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CALIFORNIA'S FORECLOSURE STATUTES: SOME PROPOSALS FOR REFORM

Cynthia A. Mertens*

I. INTRODUCTION

Spurred by the harsh economics of the Great Depression, California enacted several statutes¹ designed to protect pledgors of real property from unfair and often ruinous deficiency judgments.² This legislation includes Code of Civil Procedure sections 580a,³ the fair value section, 580b,⁴ the purchase-money anti-deficiency statute,

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1. See CAL. CIV. PROC. CODE §§ 580a, 580b, 580d & 726 (West Supp. 1986). Hereafter, all references in the text are to the California Code of Civil Procedure except as noted.

2. A deficiency occurs when a purchaser of real property defaults on the note which is secured by the property; the creditor then forecloses, but there is a "deficiency" since the sale of the property does not produce enough to pay off the balance due on the note. The creditor may sue the debtor to obtain a money judgment for that amount.

3. The fair value provisions of section 580a state that, after the property has been nonjudicially foreclosed, the beneficiary can file a complaint asking for a deficiency. The court, if requested to do so by either party, must appoint a probate tax referee to appraise the property. The court then finds the fair market value of the property at the time of sale and renders a judgment for "not more than the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value." This action for a deficiency must be brought within three months of the date of sale. CAL. CIV. PROC. CODE § 580a (West Supp. 1986).

4. Section 580b states:

No deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given to the vendor to secure payment of the balance of the purchase price of real property, or under a deed of trust, or mortgage, on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of such dwelling occupied, entirely or in part, by the purchaser.

Where both a chattel mortgage and a deed of trust or mortgage have been given to secure payment of the balance of the combined purchase price of both real and personal property, no deficiency judgment shall lie at any time under any one thereof if no deficiency judgment would lie under the deed of trust or mortgage on real property.

Id. at § 580b.

580d,⁵ the nonjudicial foreclosure anti-deficiency statute, and 726,⁶ the "one-action" rule. Three decades of judicial interpretation, however, have created a body of case law⁷ which fails to advance the legislative purposes upon which the courts purportedly base their decisions.⁸

The time has come for California to substantially revise its Depression-era anti-deficiency legislation in order to express and effectuate purposes consistent with the expectations of both debtor and creditor in today's society. Current sections 580a, 580b and 726 have generated much controversy in their application. The results obtained in the everyday application of the statutes as interpreted by the courts, are irreconcilable with the court-declared principles that underlie this legislation. Therefore, the author proposes a revision of sections 580a, 580b and 726 to bring those statutes in line with the needs of real estate borrowers and creditors today.

A. *The 580a Proposal*

Section 580a, enacted in 1933, provides that a deficiency judgment after a nonjudicial foreclosure sale shall be limited to the difference between the fair market value of the property at the time of the sale and the outstanding principal balance⁹ on the secured obligation. In 1939, however, section 580d was enacted barring all deficiency judgments after a nonjudicial foreclosure, thereby rendering section 580a obsolete.¹⁰ The author proposes an amendment of sec-

5. The pertinent paragraph of section 580d states:

No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property hereafter executed in any case in which the real property has been sold by the mortgagee or trustee under power of sale contained in such mortgage or deed of trust.

Id. at § 580d.

6. The pertinent part of section 726 states: "(a) There can be but one form of action for the recovery of any debt or the enforcement of any right secured by mortgage upon real property, which action must be in accordance with the provisions of this chapter." *Id.* at § 726.

7. The first decision of significance interpreting section 580b is *Brown v. Jensen*, 41 Cal. 2d 193, 259 P.2d 425 (1953). The next major decision, *Roseleaf v. Chierighino*, 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963), was decided ten years later.

8. The legislative purposes, first articulated in *Roseleaf*, are discussed in depth in section II part B, *infra*, of this article. See *infra* notes 57-58.

9. Section 580a permits interest to be added to the balance due. CAL. CIV. PROC. CODE § 580a (West Supp. 1986).

10. As stated by Professor John R. Hetland:

Code of Civil Procedure 580a, which affects only the nonjudicial sale, is largely, if not entirely, obsolete as a result of the subsequent enactment of Section 580d . . . , combined with the judicial determination that section 580a is inapplicable to the only large volume of secured transactions not affected by Section 580d,

tion 580a which, while leaving section 580d intact, would breathe new vitality into the dormant statute by applying its principle of fair valuation to certain foreclosure situations in which the value should, in equity, be considered by the courts.¹¹

B. *The 580b Proposal*

Section 580b currently prevents creditors from obtaining deficiency judgments after foreclosure in two cases. The statute bars any vendor of real property who has taken a note secured by that property ("seller carry-back" transaction) from obtaining a deficiency judgment.¹² It also bars a third party lender from obtaining a deficiency judgment if the loan is for the purchase of a one-to-four unit, owner-occupied residential dwelling ("residential purchase-money" loan).

As will be discussed in section II, the courts have applied the statute to a number of situations not clearly contemplated, or provided for, by the Legislature. The result is a series of opinions that give lip-service to the purported two-fold purpose¹³ of the statute but which reach results that, in the author's opinion, contravene both the express provisions of the statute and the supposed intent of the Legislature.

A growing trend in both case law¹⁴ and in legislation¹⁵ has been to provide increasing protection for homeowners, while exercising a hands-off policy in commercial transactions. The author's proposed amendments would codify this trend by incorporating the protection forwarded homeowners, while allowing deficiency judgments in com-

non-purchase-money, junior creditor. . . .

J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS § 6.1, at 234 (1970). See also R. BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 4.18, at 153-54 (1979); Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again*, 22 UCLA L. REV. 753, 753 n.1 (1975).

11. See *infra* section II part A.

12. *Roseleaf* interpreted § 580b in such a way that only vendors who carry back a note secured by a deed of trust on the actual property purchased are barred from obtaining a deficiency. See discussion of *Roseleaf* in section II part B, *infra*.

13. The two-fold purpose of section 580b, stated by the California Supreme Court, is (1) to prevent overvaluation of property given to secure the balance due on a purchase-money note, and (2) to prevent aggravation of an economic depression which would occur if debtors were burdened with personal judgments after losing their property through foreclosure. *Roseleaf*, 59 Cal. 3d at 35, 378 P.2d at 97, 27 Cal. Rptr. at 873. See *infra* notes 56-58 and accompanying text.

14. See *Spangler v. Memel*, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972); *Prunty v. Bank of America*, 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1974).

15. See *infra* section III.

mercial transactions subject to the fair value provisions of the amended section 580a.

C. *The 726 Proposal*

Section 726 provides at present that a creditor is entitled to "one form of action" when it chooses to judicially foreclose a deed of trust.¹⁶ This section has been interpreted to require a creditor to foreclose on the property before requesting a deficiency judgment.¹⁷ If the creditor does not foreclose first, the debtor may raise section 726 as an affirmative defense, and the creditor will be required to exhaust the security first before seeking a personal judgment against the debtor.¹⁸ If the creditor ignores the security and obtains a personal judgment against the debtor (because the debtor failed to raise the section 726 affirmative defense), the creditor will be prohibited from later foreclosing on the security by section 726's "sanction" effect.¹⁹

The purpose of section 726 is to protect the debtor by requiring that the security be exhausted before personal liability is imposed.²⁰ The courts, however, in applying section 726, have sometimes lost sight of the purpose of the statute and have rendered decisions which are unfair to the creditors involved.²¹ The two aspects of section 726 — affirmative defense and sanction effect — must be clarified so that the courts will apply the statute as the Legislature intended.²²

Section II of this article reviews the present statutes and case law interpreting them in order to illustrate the problems with the anti-deficiency statutes and the contexts in which they have arisen. Section III highlights the current legislative policy to give special protection to residential real estate purchasers. In section IV, the proposed statutory revisions are set out and analyzed.

II. CRITICAL ANALYSIS OF CALIFORNIA'S ANTI-DEFICIENCY LEGISLATION

Few real property purchasers can afford to pay cash for their

16. See *infra* note 26 for the "one form of action" language of section 726.

17. *Felton v. West*, 102 Cal. 266, 269, 36 P.2d 676, 679 (1894).

18. See *Salter v. Ulrich*, 22 Cal. 2d 263, 138 P.2d 7 (1943).

19. See *Walker v. Community Bank*, 10 Cal. 3d 729, 735-36, 518 P.2d 329, 333, 111 Cal. Rptr. 897, 901 (1974).

20. *Id.*

21. See *Bank of America v. Daily*, 152 Cal. App. 3d 767, 773, 199 Cal. Rptr. 557, 560 (1984).

22. See *supra* note 20 and accompanying text.

property,²³ and, even if they could afford to pay cash, many finance their purchases because of favorable tax advantages.²⁴ Generally, a purchaser of real property borrows the balance of the purchase price from either the seller or a third party lender. This loan is secured by a deed of trust on the property, thus entitling the lender to foreclose on the property should the buyer default on his or her payments.²⁵ The foreclosure may be either through the judicial process²⁶ or through a nonjudicial process.²⁷

If the creditor chooses to judicially foreclose a nonpurchase-money deed of trust,²⁸ it is entitled to a deficiency judgment if the

23. Analysis of residential sales listed in San Jose Real Estate Board's publication on *Quarterly Sales & Disposition Report* (for members only) covering the first quarter of 1984 reveals that less than one percent of all purchasers pay cash for their property. Of the 507 residences sold, only two were paid for with cash.

24. Interest paid on loans is tax deductible. Property taxes are likewise deductible. I.R.C. §§ 163, 164 (West Supp. 1986); CAL. REV. & TAX CODE § 17201 (West Supp. 1986).

25. A typical deed of trust in California contains language similar to the following:

That upon default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, Beneficiary may declare all sums secured hereby immediately due and payable by delivery to Trustee of written declaration of default and demand for sale and of written notice of default and of election to cause to be sold said property, which notice Trustee shall cause to be filed for record. Beneficiary also shall deposit with Trustee this Deed, said note and all documents evidencing expenditures secured hereby.

After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, Trustee, without demand on Trustor, shall sell said property at the time and place fixed by it in said notice of sale, either as a whole or in separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States, payable at time of sale. . . .

After deducting all costs, fees and expenses of Trustee and of this Trust, including cost of evidence of title in connection with sale, Trustee shall apply the proceeds of sale to payment of: all sums expended under the terms hereof, not then repaid, with accrued interest of the amount allowed by law in effect at the date hereof; all other sums then secured hereby; and the remainder, if any, to the person or persons legally entitled thereto.

26. CAL. CIV. PROC. CODE § 726(a) (West 1980 and Supp. 1985). Section 726(a) states that "There can be but one form of action for the recovery of any debt for the enforcement of any right secured by mortgage upon real property. . . ." Section 726(b) refers to the creditor's right to obtain a deficiency unless such a deficiency is barred by section 580b. It also contains a fair value provision similar to that of section 580a. *See supra* note 3. Section 726(e) provides that, if a deficiency is waived, the property is sold pursuant to section 716.020. (Section 716.020 sets forth the procedure to use when levying on property to satisfy a judgment.) If a deficiency is not waived or prohibited, the property is sold subject to the right of redemption in sections 729.010-729.090.

27. CAL. CIV. CODE § 2924 (West Supp. 1986) governs the nonjudicial foreclosure situation.

28. CAL. CIV. PROC. CODE § 725(a) (West Supp. 1986) states:

The beneficiary or trustee named in a deed of trust or mortgagee named in a

fair market value of the property does not equal or exceed the balance due on the note.²⁹ Since the creditor has the right to a defi-

mortgage with power of sale upon real property or any interest therein to secure a debt or other obligation, or if there be a successor or successors in interest of such beneficiary, trustee or mortgagee, then such successor or successors in interest, shall have the right to bring suit to foreclose the same in the manner and subject to the provisions, rights and remedies relating to the foreclosure of a mortgage upon such property.

Id.

29. *Id.* at § 726. Section 726 limits deficiency judgments after judicial foreclosures.

It has been suggested that fair market value, as used in Civil Procedure Code sections 580a and 726 is not to be measured by the price a willing buyer would pay pursuant to a normal sale. Rather it is the price which can be expected to be obtained under forced sale circumstances. Leipziger, *supra* note 10, at 763 n.32.

A California court of appeal noted that fair market value varies with the circumstances surrounding the foreclosure sale, and the court must consider the entire situation before making such a determination. *Nelson v. Orosco*, 117 Cal. App. 3d 73, 172 Cal. Rptr. 457 (1981). In *Nelson*, the court held that a low bid was acceptable because the land was "subject to the expense and vicissitudes of a lawsuit which could result in the purchaser obtaining nothing at all for the price he had paid." *Id.* at 79, 172 Cal. Rptr. at 460.

However, in the more recent case of *Rainer Mortgage v. Silverwood Ltd.*, 163 Cal. App. 3d 359, 209 Cal. Rptr. 294 (1985), a California appellate court significantly limited the potential impact of the broad language in *Nelson*. In *Rainer*, the creditor judicially foreclosed on the debtor's property after a default on a loan and subsequently sought a deficiency judgment. A dispute arose in the appellate court regarding the meaning of "fair value" in the context of a judicial foreclosure sale.

Rainer (the creditor), relying on *Nelson*, argued that because the borrower has the right to redeem the property within one year after a foreclosure sale (CAL. CIV. PROC. CODE §§ 729.010(a), 729.030(b)), the marketability of the property is restricted. Accordingly, he contended that the deficiency judgment should represent the difference between the immediate resale value of the property (presumably impaired by the redemption right of the borrower), and the amount of the outstanding indebtedness. 163 Cal. App. 3d at 363, 209 Cal. Rptr. at 296.

The court rejected *Rainer's* argument and concluded that the borrower's redemption right was not one of the factors to consider in determining "fair value" under the *Nelson* approach. The *Rainer* court reasoned that the *Nelson* case was distinguishable because in that case, the factor which affected merchantability was a *lis pendens* that was not a product of a foreclosure sale. The *Nelson* court had concluded that external factors must be considered in computing fair value but did not hold that internal factors, arising from the foreclosure sale itself, must be considered. Accordingly, the *Rainer* court stated that the *Nelson* decision did not apply in the *Rainer* factual setting. *Id.* at 365, 209 Cal. Rptr. at 296-97.

Finding *Nelson* inapplicable, the *Rainer* court proceeded to examine the language and legislative history of the fair value provision in section 726. The court determined that the purpose of the fair value provision was to protect the defaulting mortgagor. The court concluded that the proper measure of fair value of the property is the intrinsic value of the property at the time of sale. The court held that the rights of the creditor were not substantially impaired by the fact that resale within one year is less likely due to the redemption right of the borrower. The court reasoned that the lender was only "temporarily deprived of the property's 'fair value' and its market value as encumbered," because the right of redemption expires within one year. *Id.* at 367, 209 Cal. Rptr. at 299.

Finally, the court noted that the "risk of loss" placed on *Rainer* is fair, because it is partially a result of his own actions. *Rainer* could have elected to foreclose nonjudicially, and

ciency,³⁰ the debtor is entitled to redeem the property³¹ within a year if the proceeds of the sale do not satisfy the debt, or within three months if the proceeds equal or exceed the balance due.³² If the creditor waives the right to a deficiency,³³ the debtor has no right to redeem.³⁴

Nonjudicial foreclosure is accomplished by exercising the power of sale in a deed of trust or mortgage. Certain procedural steps must be undertaken by the trustee prior to the sale,³⁵ but there is no statutory provision for a judicial determination of the validity of the alleged default.³⁶ If the creditor forecloses nonjudicially, it has no right to a deficiency judgment against the debtor should the sale bring less than the amount due on the note.³⁷ Since the creditor cannot obtain a

then the borrower would have no right to redemption. *Id.* at 369, 209 Cal. Rptr. at 299-300.

30. This assumes the note is not purchase-money as defined in California Civil Procedure Code section 580b.

31. CAL. CIV. PROC. CODE § 729.020 (West Supp. 1986). Section 729.020 limits the right of redemption to the judgment debtor and his or her successor in interest.

Prior to July 1, 1983, the right of redemption extended to junior lienors as well as to debtors and debtor's successors-in-interest. The recent curtailment of the right of redemption was due in large part to the California Law Revision Commission's position on this matter.

The California Law Revision Commission has criticized the debtor's right of redemption because the purposes (such as forcing the purchaser at the sale to bid an amount near the property's fair value and giving the debtor another chance to save the property) have not been met. The Commission's position is that the right of redemption operates "as the greatest impediment to the achievement of the primary purpose of obtaining a fair bid at a sale of real property because the purchaser can only obtain title that is defeasible for another year or, in certain cases, three months." The Commission proposed legislation which would eliminate the statutory right of redemption after judicial sale, with the exception of cases where a deficiency judgment is sought upon foreclosure of a mortgage or deed of trust. *1981 Creditor's Remedies Legislation*, 16 CAL. L. REVISION COMM'N REPORTS 1001, 1119 (1982).

32. CAL. CIV. PROC. CODE § 729.030 (West Supp. 1986).

33. *Id.* at § 726(e).

34. *Id.* at § 701.680.

35. CAL. CIV. CODE § 2924-2924h (West Supp. 1986).

36. This nonjudicial foreclosure proceeding has been unsuccessfully challenged as a deprivation of property without adequate notice. *Garfinkle v. Superior Court*, 21 Cal. 3d 268, 578 P.2d 945, 146 Cal. Rptr. 208 (1978).

37. CAL. CIV. PROC. CODE § 580d (West 1976). See *supra* note 5 for text.

In *First Fed. Sav. and Loan Ass'n v. Lehman*, 159 Cal. App. 3d 537, 205 Cal. Rptr. 600 (1984), a California appellate court held that section 580d barred an action for fraud against the buyer because the lender had previously foreclosed on the property. The court ignored the fact that an action for fraud is a tort action and that any such recovery would not be a deficiency judgment.

Financial Code sections 779, 7459 and 7460, effective January 1, 1986, allow banks and savings and loan associations to recover damages, including punitive damages, resulting from intentional misrepresentations made by borrowers to obtain loans. The fact that the property was sold nonjudicially and that therefore a deficiency judgment would be barred by section 580d is irrelevant. However, if the loan is under \$150,000 and is secured by a single-family owner-occupied residence, the financial code sections do not apply. CAL. FIN. CODE §§ 779,

deficiency judgment, the debtor is not entitled to redeem.³⁸

A. *The Impotent Fair Value Provisions of Section 580a*

When section 580a³⁹ was enacted in 1933, it was possible for a creditor to sell the property nonjudicially and then to request a deficiency judgment against the debtor through the courts. A deficiency was available only when the fair market value was less than the balance due on the obligation.⁴⁰ On the other hand, if the debt was eliminated as a result of the sale because the sale price was equal to or exceeded the balance due, the debtor had no remedy.⁴¹ Thus, evidence of the fair market value was only relevant in determining the amount of the deficiency judgment.⁴²

In 1939, section 580d⁴³ was enacted. This section bars all deficiency judgments after nonjudicial sales. Sections 580a and 580d appear, on their face, to be inconsistent since one implies a right to a deficiency after a nonjudicial sale, and the latter section expressly bars such a deficiency. In fact, numerous commentators have expressed the belief that section 580a is obsolete.⁴⁴

7459, 7460 (West Supp. 1986).

38. After a judicial foreclosure, the creditor has the right to a deficiency, and the debtor has the right of statutory redemption. After a nonjudicial foreclosure, the creditor has no right to a deficiency, and the debtor has no right to redeem. Thus, numerous cases have stated that section 580d puts nonjudicial foreclosure on parity with judicial foreclosure. *Roseleaf*, 59 Cal. 2d at 43, 378 P.2d at 102, 27 Cal. Rptr. at 878; *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 604, 542 P.2d 981, 991, 125 Cal. Rptr. 557, 567 (1975).

39. See *supra* note 3 for a summary of CAL. CIV. PROC. CODE § 580a.

40. For example, if the property was sold for its fair market value of \$8,000 but the balance due on the note was \$12,000, the creditor would have been entitled to a deficiency judgment of \$4,000. Had the property been sold for \$7,000, the deficiency would remain \$4,000, assuming \$8,000 was the fair market value. See *supra* note 3.

41. For example, the property was sold for the amount due on the note (\$12,000 to be consistent with the example in note 38 *supra*), but its fair market value was \$15,000. The debtor could not compel the creditor to pay the difference of \$3,000, nor could she have the sale set aside.

42. There is no provision in the legislation that enables a debtor to allege that, if the property had been sold at fair market value, he or she would be entitled to the excess. For example, if the balance owed on a note is \$100,000, and the property sold for that amount at the foreclosure sale but had an actual fair market value of \$150,000, the debtor cannot claim the creditor or purchaser owes him or her \$50,000.

43. See *supra* note 5 for text of CAL. CIV. PROC. CODE § 580d.

44. However, one author has pointed out that *Spangler v. Memel*, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972), has the potential of breathing new life into Civil Procedure Code section 580a, as the section could now be applied to limit the amount of the sold-out junior's recovery. See *Leipziger*, *supra* note 10, at 753. Professor *Leipziger* states:

Presumably such a limitation would function by requiring an appraisal of the value of the property as of the time the senior lien is foreclosed; to the extent that such an appraisal indicated a value in excess of the bid at the senior sale,

The Great Depression of the 1930's was the impetus behind section 580a and the other anti-deficiency legislation that was intended to reduce or eliminate the debtor's personal liability to his or her secured creditor.⁴⁵ During the Depression, many debtors were unable to continue making payments on their notes. After default, the creditor, frequently the sole bidder at the foreclosure sale, would purchase the property for an amount far below the amount the debtor owed on the note. The creditor then obtained personal judgment against the debtor for the balance due, thus making it practically impossible for the debtor to obtain another mortgage while a substantial judgment was outstanding against him or her.⁴⁶ The Legislature attempted to correct this inequitable situation by enacting section 580a, which was intended to "prevent creditors from buying in at their own sales at deflated prices and realizing double recoveries by holding debtors for large deficiencies."⁴⁷

such excess should be deducted from the amount of the judgment made available to the junior. In other words, the junior lienholder's deficiency is measured by the difference between the fair market value of the property and the amount of the combined senior and junior debt.

Id. at 767 n.40.

The problem with the above, of course, is that the junior, to protect itself, must bid cash at the foreclosure sale. This may be financially impractical. Furthermore, the California courts have not applied Civil Procedure section 580a in this manner in any reported decisions.

However, in both *Walter E. Heller Western, Inc. v. Bloxham*, 176 Cal App. 3d 266, 221 Cal. Rptr. 425 (1985) and *Bank of Hemet v. United States*, 643 F.2d 661 (9th Cir. 1981), the courts concluded that Civil Procedure section 580a would apply to a sold-out junior who was the successful bidder at the senior's nonjudicial foreclosure sale.

See *R. BERNHARDT*, *supra* note 10, § 4.31, at 35; Benjamin, *California Fair Value Limitations Applied to Non-Foreclosing Junior Lienholder*, 12 GOLDEN GATE L. REV. 317 (1982).

The California Legislature apparently believes section 580a is still viable since it has amended the statute three times since 1939 when section 580d arguably abrogated its effect. The amendments all had to do with the language in the section. Prior to 1968, section 580a read, referring to the compensation of the appraiser appointed by the court to ascertain the fair market value of the property:

The court must fix compensation of such referee not to exceed five dollars per day, and expenses for the time actually engaged in such appraisal.

After the 1968 amendment the statute reads:

The court must fix the compensation of such referee in an amount as determined by the court to be reasonable, but such fees shall not exceed similar fees for similar services in the community where such services are rendered.

CAL. CIV. PROC. CODE § 580a (West Supp. 1986).

The 1970 amendment substituted inheritance tax "referees" for "appraisers," and the 1982 amendment substituted "probate tax referees" for "inheritance tax referees."

45. Civil Procedure Code sections 580a and 580b were enacted in 1933; section 580d was enacted in 1939. Civil Procedure Code section 726 was amended in 1933.

46. See, *Recent Legislation*, 22 CALIF. L. REV. 170, 181-83 (1934).

47. *Roseleaf*, 59 Cal. 2d at 40, 378 P.2d at 99, 27 Cal. Rptr. at 875. See, e.g., *Walker v.*

The author has found no reported California decisions applying section 580a as the Legislature intended. From 1933, when section 580a was first enacted, until 1939, when section 580d became effective, the courts refused to apply section 580a to deeds of trust or mortgages executed prior to the statute's enactment.⁴⁸ Since the country was recovering from the Depression throughout those years when the section had significance (1933-39), it can be surmised that few deeds of trust were executed in California during that period. Therefore few, if any, debtors were able to raise section 580a as a defense to deficiency judgments.

One California court has recently taken the opportunity to apply section 580a in the context of a sold-out junior who was the high bidder at the senior foreclosure sale. In *Walter E. Heller Western, Inc. v. Bloxham*,⁴⁹ the court held that the fair value provisions of section 580a limited the amount that the junior could recover as a deficiency judgment. The amount was limited to "the lesser of the excess of the combined debts of the senior and junior lienholders over 1) the fair market value of the property or 2) the selling price at the foreclosure sale."⁵⁰ The court reasoned that, once a junior chose to purchase at the senior's sale, it was equitable to impose the fair value limitations on him in order to bar double recovery — receipt of both the property at a bargain price and the entire amount due on his note.⁵¹ Since the junior chose to bid and was in fact the high bidder, he was in control of the price at which the property was sold. This can be distinguished from the situation in which a junior does not bid at the senior sale, for "[t]o apply the fair value limitations to that junior would result in the amount of his deficiency being limited by the amount of someone else's bid, a factor over which he has no control."⁵²

Debtors have also raised section 580a unsuccessfully in the multiple security context. If a creditor nonjudicially forecloses on only

Community Bank, 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974).

48. See, e.g., *Miller v. Hart*, 11 Cal. 2d 739, 81 P.2d 923 (1938); *Central Bank v. Proctor*, 5 Cal. 2d 237, 54 P.2d 718 (1936). The rationale behind the courts' refusal was two-fold: (1) the statute did not specify that it was to be applied retroactively, and (2) to eliminate anticipated deficiency judgments would have been a denial of the creditor's contractual rights under the guise of a change in available remedies. See *Bank of America Nat'l Trust & Sav. Ass'n v. Burg Bros.*, 31 Cal. App. 2d 352, 88 P.2d 196 (1939).

49. 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985). See also *Bank of Hemet*, 643 F.2d at 667-70.

50. 176 Cal. App. 3d at 273, 221 Cal. Rptr. at 429.

51. *Id.* at 273-74, 221 Cal. Rptr. at 429-30.

52. *Id.*

one parcel of its multiple security and then attempts to sell the remaining security to satisfy the balance due on the note, a debtor may argue that had the first parcel been sold at its fair market value, there would be no need for the creditor to sell the second parcel.⁵³ For example, two parcels of property secure one \$20,000 note. The debtor defaults. The creditor nonjudicially forecloses on parcel #1 and sells it for \$10,000, although its fair market value is \$20,000. The creditor then attempts to sell parcel #2 in order to recoup the additional \$10,000 owed. The debtor might attempt to enjoin the sale of parcel #2 by arguing that if parcel #1 had been sold for its fair market value as mandated by section 580a, no balance would be owed.

This was the plaintiff's contention in *Hatch v. Security First National Bank*.⁵⁴ In *Hatch*, the defendants nonjudicially foreclosed on the primary part of the security. Part of the debt remained unsatisfied, and the creditor later foreclosed on the remaining property to satisfy the balance due on the note. Plaintiff debtors brought a quiet title action with respect to the property that was sold at the second sale, contending that the fair market value of the primary security was sufficient to satisfy the debt. They argued, therefore, that they owned the remaining security free of the creditor's lien. The plaintiffs suggested that section 580a required the defendants to obtain a judicial determination of the fair market value of the first parcel sold to determine if there was, in fact, an unpaid balance due on the note before permitting the second sale. The defendants claimed that section 580a only applies when the creditor is seeking a deficiency judgment, defined as a money judgment,⁵⁵ after sale of all secured property, and not where the creditor is merely selling additional security. The court agreed with defendants, holding that the statute allows debtors to raise fair market value only to limit a money judgment and does not affect the creditor's right to sell additional security.

Parties relying on section 580a have not fared well in the courts. The *Bloxham* and *Hatch* cases add little meaning to this statute. At best, section 580a as it now stands is ambiguous; at worst, it is superseded by section 580d. In order to truly prevent creditors from realizing double recoveries, the fair value provisions must be given a new meaning, as will be addressed further in section IV, below.

53. This situation faced the court in *Hatch v. Security First Nat'l Bank*, 19 Cal. 2d 254, 120 P.2d 869 (1949).

54. *Id.*

55. *Id.* at 260, 120 P.2d at 873.

B. *The Untenable "Purposes" of Section 580b*

The purposes of section 580b, as articulated by the California Supreme Court in the landmark decision of *Roseleaf v. Chierighino*⁵⁶ are two-fold: (1) to prevent overvaluation of property given to secure the balance due on a purchase-money note, and (2) to prevent aggravation of an economic depression that would occur if debtors were burdened with personal judgments after losing their property through foreclosure.⁵⁷ The validity of these purposes, which has been analyzed in numerous other articles,⁵⁸ is seriously questioned. Before proposing statutory reform, the author will examine the factual situation of *Roseleaf*.

56. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

57. It is interesting to note that neither party in *Roseleaf* argued that this was section 580b's two-fold purpose in either their District Court of Appeal briefs or the Petition for Hearing before the California Supreme Court. The briefs are on microfilm at Santa Clara University law library. The *Roseleaf* court cites Currie and Lieberman, *Purchase-Money Mortgages and State Lines: A Study in Conflict-of-Laws Method*, 1960 DUKE L.J. 1, 33-34, 39-40, to support its statement that, "Section 580b places the risk of inadequate security on the purchase-money mortgagee. A vendor is thus discouraged from overvaluing the security. Precarious land promotion schemes are discouraged, for the security value of the land gives purchasers a clue as to its true market value." 59 Cal. 2d at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877. The Currie & Lieberman article reviewed several possible explanations behind the legislative policy of barring deficiency judgments in purchase-money cases. Currie & Lieberman, *supra*, at 29-32. The authors note two possibilities: (1) the seller who forecloses a purchase-money security instrument is usually the purchaser at the sale, and he is restored to his original position without compensation, since he keeps whatever payments the buyer made, and (2) the seller has not parted with cash; he is "not lending money but trading — or even 'speculating' (footnote omitted) — in land." *Id.* at 30.

They reject the *Brown* view that "[t]he one taking such a trust deed [i.e., a vendor taking a purchase-money mortgage] knows the value of his security and assumes the risk that it may become inadequate." *Brown*, 41 Cal. 2d at 197, 259 P.2d at 427. Currie and Lieberman comment, "[t]his is not a particularly convincing explanation of the legislative purpose." Currie & Lieberman, *supra*, at 31.

Currie and Lieberman try to ascertain why a vendor would extend credit and conclude that "the likelihood is that the purchaser is unable to make a down payment sufficient to satisfy the [lending] agency's loan-value ratio standards." *Id.* at 33. The vendor may seek "to compensate himself for the risk that the security is inadequate, as by charging relatively high interest, or increasing the price." *Id.*

This is apparently where the *Roseleaf* court got the overvaluation rationale.

58. The list of law review articles which discuss and criticize the *Roseleaf* purposes is extensive. Among the most significant are: Hetland, *Deficiency Judgment Limitations in California — A New Judicial Approach*, 51 CALIF. L. REV. 1, 28-31 (1963); Leipziger, *supra* note 10, at 753; Rintala (Brudno), *California's Anti-deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes*, 17 UCLA L. REV. 245 (1969). There is no use repeating extensively what has been done elsewhere, so the discussion here will be as short as possible.

1. *Roseleaf: Commercial Borrower/Multiple Security*

The debtor in *Roseleaf* had signed four notes, each representing a fraction of the purchase price for a hotel. One of the notes was secured by a first deed of trust on the hotel and was not in default. Three of the notes were secured by second deeds of trust on other property owned by the debtor. The holder of all of these notes was the vendor, the *Roseleaf Corporation*. The security for the three notes secured by second deeds of trust on the other property became valueless when the first deeds of trust were foreclosed. The debtor had likewise defaulted on the seconds held by *Roseleaf Corporation*, and the corporation sued the debtor directly on these three notes.

The debtor's defense was that these were purchase-money notes since they represented a debt incurred by virtue of the purchase of the hotel, and therefore the corporation could not seek the balance due on these notes. According to the debtor, this would be a deficiency judgment prohibited by section 580b. This defense was based on *Brown v. Jensen*,⁵⁹ which also involved a sold-out junior, and in which the sold-out junior was prohibited from suing on the note, since the note was determined to be "purchase-money" within the meaning of section 580b. In *Brown*, however, the creditor had taken a second deed of trust on the property sold, not on additional security as in *Roseleaf*.

The court in *Roseleaf* allowed the creditor to sue directly on the notes, since it determined that the purposes of section 580b would not be contravened by allowing this deficiency.⁶⁰ The Court found no evidence that the hotel had been overvalued, and in fact, correctly noted that, had the debtor been protected from suit on the three notes by section 580b, he would have been able to obtain the hotel for less than the agreed-upon price by simply keeping up his payments on the note secured by the first deed of trust on the hotel.⁶¹

The *Roseleaf* result can be attacked on two bases. First, the pertinent language of the statute in effect at the time *Roseleaf* was decided stated, "[n]o deficiency judgment shall lie in any event after any sale of real property for failure of the purchaser to complete his contract of sale, or under a deed of trust, or mortgage, given to secure payment of the balance of the purchase price of real property."⁶²

59. 41 Cal. 2d 193, 259 P.2d 425 (1953).

60. *Roseleaf*, 59 Cal. 2d at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877.

61. *Id.* at 42-43, 378 P.2d at 101, 27 Cal. Rptr. at 877.

62. *Id.*

This is easily susceptible of an interpretation that would bar a deficiency judgment after the sale of the additional security in *Roseleaf*. Where security is given to secure payment of the balance of the purchase price of real property, the statute does not require that the property sold be the property that was purchased.

More importantly, the creditor's request for additional security could easily indicate the property being sold is overvalued. A creditor who insists that the debtor give additional security may very well be uncertain or skeptical about the value of his or her property. Had the hotel in *Roseleaf* actually been worth \$200,000, and had the debtor paid \$40,000 down, the creditor should have had no hesitancy in accepting a note for \$160,000 secured by a first deed of trust on the hotel. But if, in reality, the hotel was only worth \$100,000, but the purchase price was \$200,000, the seller probably would not accept \$40,000 down with a note for \$160,000 because it would leave the seller with insufficient security.⁶³ Instead, the seller might take the \$40,000, accept a note for \$60,000, secured by a first deed of trust on the hotel,⁶⁴ and then require the buyer to provide notes for the remaining \$100,000 debt, secured by other property.⁶⁵

Thus, the request for additional security could very well be an indication of overvaluation, a result which the application of section 580b might avoid. If the creditor could not get a deficiency on the notes secured by additional property, he or she would arguably have less incentive to overvalue the property sold. Since *Roseleaf* allows the deficiency, overvaluation may actually be encouraged.⁶⁶

63. On the other hand, a seller may secure the balance of the \$200,000 purchase price on a hotel with a \$100,000 fair market value by accepting \$40,000 down and a \$160,000 note. If the buyer defaulted, the seller could foreclose and enter a credit bid of up to \$160,000, depending on the balance due on the note at the time of foreclosure. The seller would retain the \$40,000 down payment and, if he or she is the high bidder at the sale, would have property with a fair market value of \$100,000. By overvaluing the security initially, the seller could make \$140,000 on property worth \$100,000. The bar against obtaining a deficiency would not discourage this.

64. This would leave the seller with a margin of security. Depending on how great a margin of security the seller wanted and what the value of the debtor's other property was, the amount of the note secured by the property purchased could be reduced, and the amount secured by other property increased. The seller may be willing to accept a note for up to \$100,000, the full market value of the property, but this would leave the seller with no margin of security.

65. This is typically referred to as "fragmented" or "fractionalized" debt; that is, a debt which is split into separate notes. Each note may be secured by a separate deed of trust, or one note may be secured and another unsecured. *Roseleaf* involved this type of debt. See R. BERNHARDT, *supra* note 10, §§ 2.58-2.61, at 61-66; Leipziger, *supra* note 10, at 758 n.20.

66. One could argue that a creditor in the *Roseleaf* situation requests additional security, not because the hotel at the time of sale is overvalued, but because of the fear that the

There was no discussion by the court in *Roseleaf* about the statute's second purpose, how the transaction would or would not prevent further economic decline.⁶⁷ Apparently, the court felt no need to discuss this, as it is only relevant in a declining market where debtors as a class may be burdened with both loss of the property financed and large personal liabilities.

2. *Brown: Residential Borrower/Single Security*

Numerous commentators contend that *Roseleaf* severely undercuts *Brown v. Jensen*.⁶⁸ However, as noted previously, *Brown* involved a second deed of trust on the property purchased, whereas in *Roseleaf*, the seconds were given on property other than the parcel purchased. Two views of the *Brown* transaction are possible. One is that the property in *Brown* could not have been overvalued, as the seller agreed to take a second, obviously believing the value of the property to be sufficient to cover the note. The vendor "knows the value of his security and assumes the risk that it may become inadequate."⁶⁹ However, third-party lenders are in a better position to know the value of the security they are taking than is the average vendor.⁷⁰ Therefore, it is difficult to understand why section 580b does not apply to third-party lenders if, as stated in *Roseleaf*, the section was intended to prevent overvaluation. Furthermore, if a seller is sold-out by a senior's foreclosure sale as in *Brown*, why should that seller automatically be barred from suing on his or her note? There was no overvaluation initially, and the seller may simply not have been in the financial position to bid cash at the senior

debtor-purchaser may not have the business skill to keep the business operating at its present value. Certainly, the profits of such an enterprise are taken into consideration in setting the purchase price. This, however, was not discussed by the court in *Roseleaf*.

The *Roseleaf* purpose to prevent overvaluation is achieved if the buyer, by the vendor's request for additional security, is put on notice that the purchase price is questionable. This assumes the buyer will refuse to go ahead with the purchase, and the vendor will thus be unable to sell his property at the inflated price. See R. BERNHARDT, *supra* note 10, § 4.24, at 157-58; Rintala, *supra* note 58, at 261-62; Leipziger, *supra* note 10, at 762 n.31.

67. The only sentences referring to economic decline in *Roseleaf* state:

If inadequacy of the security results, not from overvaluing, but from a decline in property values during a general or local depression, section 580b prevents the aggravation of the downturn that would result if defaulting purchasers were burdened with a large personal liability. Section 580b thus serves as a stabilizing factor in land sales.

59 Cal. 2d at 42, 378 P.2d at 101, 27 Cal. Rptr. at 877.

68. Most significant among them is Professor John Hetland. See J. HETLAND, *supra* note 10, §§ 6.29-6.34, at 280-90. See also R. BERNHARDT, *supra* note 10, § 4.23, at 156.

69. *Brown*, 41 Cal. 2d at 197, 259 P.2d at 427.

70. See Currie & Lieberman, *supra* note 57, at 31-32.

sale.

On the other hand, the *Brown* vendor may have purposely overvalued the property, hoping that the debtor would pay the entire amount represented by the note.⁷¹ A vendor in such a situation has nothing to lose by overvaluing; even if he is aware that no deficiency is obtainable, he may consciously take a calculated risk that the buyer will pay the full note. Traditionally, real property values increase over time; a purchaser who agrees to pay an overvalued price for property may find that property to be worth that price in a few years. In such a situation, a default would be economically unsound.⁷² The fact that no deficiency is available does not discourage the vendor from overvaluing the property.

The inevitable conclusion is either that preventing overvaluation of property was never intended to be achieved through the application of section 580b or, even if the Legislature intended such a purpose, application of the section does not achieve that end. Sellers may overvalue property even if they cannot obtain a deficiency in the hope that the purchase price will eventually be paid in full, or they may overvalue property by securing the balance of the purchase price with property other than that sold and be able to get a deficiency on those notes. In either case, section 580b does not prevent overvaluation. As applied in *Roseleaf*, it may even encourage it.

3. *Spangler: Commercial Borrower/Subordination*

The California Supreme Court reaffirmed *Brown's* validity in *Spangler v. Memel*.⁷³ In *Spangler*, the seller subordinated her purchase-money deed of trust to a construction loan that was used to build an office building on the property purchased from the seller, whereas in *Brown*, the loan was secured by a second on what was apparently residential property.⁷⁴ *Spangler* permitted the sold-out junior to sue on her note after the holder of the first had foreclosed

71. See *infra* note 72.

72. For example, in 1982 a debtor agreed to pay \$100,000 for a house which had a fair market value of \$75,000. He paid \$10,000 down and owed \$90,000. He makes payments on the note for three years. The house, in 1985, may easily be worth the \$100,000 he agreed to pay for it in 1982. The probability of a buyer defaulting decreases as the market value increases. If the vendor in this example carried the balance of the purchase price, he has little to fear from the fact that he cannot obtain a deficiency.

73. 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972). Professor Leipziger analyzes *Spangler* in depth in his article, *supra* note 10.

74. The *Brown* opinion itself gives no indication as to whether the property was residential or commercial. However, the court in *Spangler* implied it was residential. 7 Cal. 3d at 609-11, 498 P.2d at 1058-59, 102 Cal. Rptr. at 810-11.

on the property.

The *Spangler* court, applying the purposes of section 580b as first put forth in *Roseleaf*, concluded these purposes would be best met by allowing the seller to obtain a deficiency in this non-standard transaction. The rationale was that, since the buyer is the one constructing and developing the property, it is the buyer/developer and not the seller who controls its fair market value. The seller cannot rely on the security value of the property when he agrees to subordinate his security, since the value of the unconstructed building is speculative at best. Because the seller has no way of calculating the fair market value of the property once construction is completed, he cannot overvalue the property, and thus there is no reason to deny him a deficiency.⁷⁵

The *Spangler* court, in giving the vendor who subordinates to a buyer/developer the right to a deficiency, molded its reasoning to fit *Roseleaf's* overvaluation rationale. To do this, it was forced to look at the transaction from the buyer/developer perspective, deciding that if the buyer/developer were held liable in this context, it would be unlikely to overvalue proposed construction. Supposedly, the fear of personal liability on the seller's subordinated note will encourage the buyer/developer to ensure that the fair market value of the property after it is built will equal or exceed the balance due on the notes for which the property is security.

While this fear of personal liability may influence some developers, it is unlikely that this is a significant factor in their decision-making process.⁷⁶ Developers who are undercapitalized are frequently unconcerned about their personal liability. Financially strong developers will either shield themselves from liability by having a corporate entity purchase the property and sign the note⁷⁷ or will avoid risky projects altogether. It is questionable whether imposing personal liability will discourage overvaluation in this context.

Spangler also examined *Roseleaf's* second purpose — preventing the aggravation of an economic depression — but considered this purpose to have little applicability.⁷⁸ The court reasoned that, since neither the buyer nor the subordinated seller will have the property after the holder of the first forecloses, the buyer/developer in this context should bear the cost of the unpaid portion of the purchase

75. 7 Cal. 3d at 611, 498 P.2d at 1059-60, 102 Cal. Rptr. at 811-12.

76. Professor Leipziger's discussion of this aspect of *Spangler* is excellent. Leipziger, *supra* note 10, at 769-71.

77. *Id.* at 770-71.

78. 7 Cal. 3d at 614, 498 P.2d at 1062, 102 Cal. Rptr. at 814.

price. This view does not take into consideration the *Roseleaf* court's view that the imposition of loss of the property and personal liability on the buyer increase the effects of an economic depression. *Spangler* apparently views this double loss as a neutral factor without in any way distinguishing subordinated sellers in the commercial context from other sellers who take back junior liens.⁷⁹

4. *Budget Realty: Commercial Borrower/Unexercised Subordination*

The issue of sellers who subordinate their liens to construction financing also came up in *Budget Realty v. Hunter*.⁸⁰ In this case, the buyer purchased commercial property, taking it subject to an existing first deed of trust. The seller carried back a second deed of trust on the property. The seller also agreed to subordinate its liens to construction financing which was not to exceed \$400,000.00. The subordination agreement for construction financing was never exercised.

The buyer defaulted on the senior deed of trust, and the senior nonjudicially foreclosed on the property. The seller was sold out and filed suit to recover on the note. The buyer claimed that there was no recovery because the note was purchase-money, and the buyer was consequently protected by section 580b.⁸¹

The seller, of course, contended that because of the subordination agreement, this case fell within the exception to section 580b that was articulated in *Spangler*. The court, however, held that with an unexercised subordination agreement, the transaction retains its purchase-money character.⁸² The *Budget Realty* court analyzed the *Spangler* decision but was not persuaded that the *Spangler* result was mandated by the *Roseleaf* purposes (i.e. overvaluation and aggravation of economic downturn).⁸³ Instead, according to the *Budget Realty* court, *Spangler* required that the seller be allowed to obtain a deficiency because of the unique risks a seller takes when subordinating to a construction loan. Construction loans are generally large and usually far exceed the price paid for the land. If the buyer defaults, the seller may not be able to keep the senior current. These

79. Leipzig, *supra* note 10, at 766 n.37. See also Professor Leipzig's discussion of the problems that juniors, who do not fall within the *Spangler* factual context, face in attempting to reinstate defaults on senior notes. *Id.* at 777-78.

80. 157 Cal. App. 3d 511, 204 Cal. Rptr. 48 (1984).

81. *Id.* at 513, 204 Cal. Rptr. at 49.

82. *Id.* at 517, 204 Cal. Rptr. at 52.

83. *Id.* at 515-16, 204 Cal. Rptr. at 50-51.

additional burdens on the seller only arise after subordination.⁸⁴

The *Budget Realty*⁸⁵ court was one of the few courts to analyze a purchase-money transaction without relying on the *Roseleaf* purposes. Instead, the court took a pragmatic approach and considered how the specific fact pattern was similar to or different from the typical purchase-money situation. The court determined that there was no practical reason to protect the seller in this instance.⁸⁶ Also, the court noted the commercial character of the property and recognized that commercial transactions should perhaps be outside of the scope of section 580b. Nonetheless, the court adopted a hands-off stance, rightfully concluding that it is up to the Legislature to amend the statute if this is its intention.⁸⁷

5. *Prunty: Residential Borrower/Construction Loan*

The court of appeal in *Prunty v. Bank of America*⁸⁸ recognized the plight of the residential purchaser more directly than has the California Supreme Court to date. *Prunty* did not involve a sold-out junior and is therefore distinguishable from *Brown*, *Roseleaf* and *Spangler* in this regard. But it did involve residential borrowers who had constructed their home on a fully paid for lot through a loan obtained from Bank of America. The home was subsequently destroyed by a landslide, and the borrowers sought a declaratory judgment that they were protected from a deficiency judgment by section 580b. The court, in holding for the borrowers, concluded that this would discourage overvalued construction lending, since banks and other lenders, knowing they could not sue on the note, would lend only as much as the finished building would be worth.

The court, in insisting on conforming its reasoning to *Roseleaf's* purposes, again failed to look at the realities of construction lending.⁸⁹ Established construction lenders do not lend more than the property will be worth after construction. Construction lenders materially analyze the costs of construction prior to making the loan, and then oversee the progress of construction by releasing specific amounts of the loan as needed. Should it ever appear that the funds are not being used to increase the value of the property, further disbursements will not be made. The lender in the *Prunty* situation

84. *Id.* at 516-17, 204 Cal. Rptr. at 51.

85. *Id.*

86. *Id.* at 517, 204 Cal. Rptr. at 52.

87. *Id.*

88. 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1974).

89. See Leipziger, *supra* note 10, at 785.

also has the fully paid for lot as security. This makes it highly unlikely that the amount of the loan will exceed the value of the completed residence and lot. The motivating factor of preventing overvaluation is not met by barring a deficiency in this context. It is sound construction lending practices that discourage overvaluation.

The *Prunty* court also addressed the economic stabilization purpose of section 580b but, instead of applying it in the context of the economy as a whole as originally envisioned in *Roseleaf*, applied it to the Pruntys individually. Its reasoning was that if the Pruntys, or borrowers like them, were held liable for a deficiency after losing their home, the economic consequences to them would be extreme. The bank can best bear the risk of such economic disaster, and it did, after all, have the opportunity to oversee the construction plans and thus could have protected itself.⁹⁰

The rationale becomes questionable when carried over to other situations covered by section 580b. As Professor Leipziger comments,⁹¹ there is nothing in section 580b to prevent a third party lender of funds for a commercial building which is destroyed by a landslide from collecting a deficiency. However, a vendor who carries a junior lien for the balance of the purchase price secured by commercial property which is subsequently destroyed is not permitted to

90. The court did not draw a distinction between the sold-out junior vendor in *Spangler* and the institutional lender in *Prunty*. In *Spangler*, as discussed *supra* in notes 73-79 and accompanying text, the subordinated junior vendor was not charged with knowledge of what the completed structure's value would be, whereas in *Prunty*, the sophisticated institutional lender was.

Two other cases deserve mention. In *Goodyear v. Mack*, 159 Cal. App. 3d 654, 205 Cal. Rptr. 702 (1984), a California appellate court held that a note which was originally purchase-money lost its purchase-money protection when it was refinanced, and the new note was secured by property other than that purchased. The court examined the facts in the case in light of the purposes articulated in *Roseleaf*, but concluded that a deficiency judgment should be granted.

First, the court noted that there was no evidence that the seller overvalued the property. The refinanced note was secured by property other than that purchased, and there was no reason to assume that the seller had a greater knowledge of the value of this land than the buyers did. Second, the court reasoned that imposing a deficiency judgment would not cause an aggravated economic downturn, but instead would only insure that the buyers paid the purchase price to which they had agreed.

The court also noted that, technically, a refinanced loan is not purchase-money. In such a situation, the money is not borrowed from a seller of property or for the purchase of a one-to-four unit dwelling, but is instead borrowed to pay off an existing loan. In *Union Bank v. Wendland*, 54 Cal. App. 3d 393, 126 Cal. Rptr. 549 (1976), the court of appeal held that debtors who refinanced the loan on their residence lost section 580b's purchase-money protection against a deficiency judgment. The court, in so deciding, simply stated: "The loan transactions . . . are variations from the standard that do not come within the purpose of section 580b." *Id.* at 399-400, 126 Cal. Rptr. at 554.

91. Leipziger, *supra* note 10, at 786.

sue on his note under a literal construction of the statute. Yet that seller may very well be in the position of the seller in *Spangler*: the first lien is large and therefore cannot easily be reinstated or paid off, and thus the seller is without a remedy.

The *Prunty* court reached the correct conclusion when viewed from the residential/commercial distinction, but its reliance on the *Roseleaf* purposes weakens the analysis. The court would have done a greater service to the residential homeowner by simply relying on the legislative intent as deduced from the 1963 amendment to section 580b.⁹²

6. *Nickerman: Nonstandard Purchase-Money Transaction*

In *Nickerman v. Ryan*,⁹³ the court granted plaintiff a deficiency judgment on a secured note given pursuant to an agreement resulting from a divorce decree. The plaintiff conveyed her interest, as a tenant in common, to her husband in certain parcels of land and took back a second deed of trust on the property. When the senior foreclosed on the first deed of trust, she sued on the underlying note.

Defendant contended that he was immune from a deficiency judgment (under section 580b) because the second deed of trust represented a purchase-money note. He claimed that his ex-wife qualified as a vendor in the transaction by selling her interest in the property to him and by taking back a \$25,000 deed of trust on the property. The court disagreed with the defendant, and held that the note was not given to secure the balance of the purchase price of property. It was intended to equalize the division of a community property settlement and was thus not subject to the anti-deficiency legislation.⁹⁴

The court, in relying on *Spangler v. Memel*,⁹⁵ stated that the transaction "is such a variation on the standard purchase money

92. The court in *Prunty* analyzed the 1963 amendment in detail and concluded that the amendment required section 580b's protection to extend to residential construction borrowers. It relied on the fact that prior to 1963, section 580b simply stated that "[n]o deficiency judgment shall lie in any event after any sale under a deed of trust or mortgage given to secure payment of the balance of the purchase price of real property." In 1963, the Legislature amended section 580b to include money advanced by third party lenders used to purchase a one-to-four unit dwelling occupied by the purchaser. The use of the words "lender" and "dwelling" in the 1963 amendment allowed the *Prunty* court to conclude that the Legislature intended to protect residential purchaser-borrowers. See also R. BERNHARDT, *supra* note 10, § 4.26, at 160-61.

93. 93 Cal. App. 3d 564, 155 Cal. Rptr. 830 (1979).

94. *Id.* at 566-67, 155 Cal. Rptr. at 831.

95. 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr 807 (1972).

mortgage or deed of trust transaction that it would not subserve the purposes of section 580b . . . to deny a deficiency judgment."⁹⁶ The court then proceeded to apply principles of *Spangler* and concluded that it would be unfair to place the risk of the business venture upon the vendor who sold her interest in order to free herself from the risks and responsibilities of management of the property. The court also felt that there was no reason to assume that the seller had superior knowledge of the value of the property sold.⁹⁷

The California courts have struggled to apply *Roseleaf's* analysis to achieve protection for the residential purchaser. In *Roseleaf* and *Spangler*, where commercial transactions were involved, the sold-out juniors were permitted to sue on their notes. In *Brown*, presumably a residential situation,⁹⁸ and in *Prunty*, this was not so. The effort to protect the residential owners has led to rationales based on the *Roseleaf* purposes which do not withstand close scrutiny.⁹⁹ Those purposes should be abandoned, and the real purpose, protection of the residential purchaser, should be articulated and promoted.

C. The "One-Action Rule" of Section 726

The purpose of the "one-action rule" contained in section 726 is to protect the debtor from unnecessary personal liability by requiring the creditor to exhaust real property security before obtaining a judgment against a debtor personally.¹⁰⁰ Under this section, the debtor may challenge a creditor who fails to foreclose on the property in two ways. First, he or she may raise section 726 as an affirmative defense in a judicial foreclosure action.¹⁰¹ This will require the creditor to foreclose on secured property first. If the debtor does not compel the creditor to foreclose on all the security first by raising section 726 as an affirmative defense, the creditor should still be able to obtain a deficiency.¹⁰² Of course, after the creditor has elected the

96. 93 Cal. App. 3d at 566-67, 155 Cal. Rptr. at 831.

97. See R. BERNHARDT, *supra* note 10, § 4.32, at 35-36.

98. See *supra* note 74.

99. See *supra* note 58 for other commentators who agree with the author.

100. See *Walker v. Community Bank*, 10 Cal. 3d 729, 735-36, 518 P.2d 329, 335, 111 Cal. Rptr. 897, 901 (1974).

101. See *Salter v. Ulrich*, 22 Cal. 2d 263, 138 P.2d 7 (1943).

102. There is some dispute as to whether a creditor who does not exhaust all the security in one action is still entitled to a deficiency judgment. Professor Hetland, without explanation, says that the creditor is not entitled to a deficiency. J. HETLAND, *supra* note 10, § 6.18, at 257-58. Professor Hetland is cited with approval as to this point in *Walker*, 10 Cal. 3d at 733 n.2, 518 P.2d at 331 n.2, 111 Cal. Rptr. at 899-900 n.2. It is the author's contention that

remedy of personal action, the debtor may raise the "sanction" aspect of section 726.¹⁰³ The creditor is thus subsequently estopped from ever going after the security to satisfy the debt.

In the recent case of *Bank of America v. Daily*,¹⁰⁴ however, a California appellate court applied section 726 in a manner which was advantageous to the debtor but unfair to the creditor. In *Daily*, the bank held a \$340,000 promissory note which was secured by both the debtor's common stock and an interest in real property. When the loan was in default, the bank sold the pledged stock at a private sale and setoff \$10,000 from the Dailys' checking account to pay accrued interest. Approximately \$170,000 remained to be paid on the debt. At this time, the bank sued to judicially foreclose on the real property. The court barred the foreclosure and prohibited any deficiency.

The holding of the *Daily* court must be closely questioned. After reviewing a California Supreme Court case from 1897, the court determined that a bank setoff was an "action" within the meaning of section 726, and therefore, the bank was estopped from resorting to the real property security.¹⁰⁵ The debtors had successfully raised the "sanction" effect of section 726. The court further held that the bank could not get a deficiency judgment.¹⁰⁶ The court wrote that "[t]he harshness flowing from applying section 726 as a sanction is necessary to uphold the statutory policy of protecting debtors' rights."¹⁰⁷ Under the statute, however, the creditor is only estopped from going after the secured property to collect the debt; it should not be prevented from obtaining a deficiency judgment.

The harsh and erroneous decision in *Daily* illustrates the ambiguity of section 726's sanction effect. The *Daily* case also indicates a need to define more narrowly the term "action" within the "one-action" rule.

The Legislature has recently attempted to clarify the application of the "one-action" rule in the multiple security context.¹⁰⁸ Commercial Code section 9501, effective January 1, 1986, allows a

there is no justification for such a double sanction. See discussion of *Bank of America v. Daily*, 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984) in Rowan & Mertens, *Bank of America v. Daily: Setoff Versus Right to Foreclose*, 8 CEB REAL PROPERTY LAW REPORTER 73 (1985).

103. See *Walker*, 10 Cal. 3d at 735-36, 111 Cal Rptr. at 901.

104. 152 Cal. App. 3d at 767, 199 Cal. Rptr. at 557. For a critical analysis of the *Daily* decision, see Rowan & Mertens, *supra* note 102, at 73.

105. 152 Cal. App. 3d at 771, 199 Cal. Rptr. at 559.

106. *Id.* at 773, 199 Cal. Rptr. at 560.

107. *Id.* at 772, 199 Cal. Rptr. at 560. See Rowan & Mertens, *supra* note 102.

108. CAL. COM. CODE § 9501(4) (West 1964 & Supp. 1986).

creditor holding both personal and real property as security for a single obligation, to either foreclose on the personal property collateral independent of the real property, or to foreclose on both the personal and real property in accordance with the rules applicable to real property. If a creditor judicially forecloses solely on the personal property, and does not obtain a monetary judgment, the sanction effect of section 726 no longer bars an attempt to proceed against the real property.

Section 9501 fails to specifically address the *Daily* situation because the bank account in *Daily* was not pledged as security. The section does, however, state that a "judicial action shall not constitute an action within the meaning of section 726 if and only if a monetary judgment on the debt is sought against the debtor."¹⁰⁹ Thus, had the *Daily* facts included a multiple security situation, the bank offset would not have been an "action" for the purposes of the one-action rule of section 726.

III. RECENT LEGISLATION PROTECTING RESIDENTIAL PURCHASERS

As an examination of recent legislation will show, the California Legislature has established a trend in recent years to make special provisions for residential owners, as distinguished from commercial owners of real property. Although there are minor inconsistencies in the recent statutes (*i.e.*, in some places the language refers to "single-family, owner-occupied dwelling"¹¹⁰ and in other places to "one-to-four family residence"¹¹¹), the intent of the Legislature is obviously to provide extra protection for residential property owners in certain circumstances.

A. *Impound Accounts*

Provisions regulating impound accounts¹¹² for single-family owner-occupied dwellings were codified by the California Legislature in Civil Code section 2954 as early as 1961.¹¹³ Thus, even prior

109. *Id.*

110. *See, e.g.*, CAL. CIV. CODE §§ 2949, 2954, 2954.4 (West Supp. 1986).

111. *Id.* at §§ 2924.6, 2954.2, 2954.8, 2954.9.

112. An impound account is an account containing money for the payment of taxes, insurance, homeowner's assessments and such. A percentage of the amount due is paid monthly along with the mortgage payment by the debtor. Impound accounts are regulated by Civil Code sections 2954 and 2954.8. CAL. CIV. CODE §§ 2954, 2954.8 (West Supp. 1986). *See also id.* at §§ 2954.1, 2954.2.

113. Civil Code sections 2954(a) and (c) state in part:

to *Roseleaf Corp. v. Chierighino*¹¹⁴ and the subsequent amendment of section 580b defining a purchase-money mortgage, the Legislature was making special provisions for residential property owners. Civil Code section 2954 provides that impound accounts can only be required in certain situations; for example, when the amount of the loan is 90% of the sale price. The statute also provides that the beneficiary must account to the debtor for money received. However, it affords protection only if the loan is procured for a "single-family, owner-occupied dwelling," and the borrower will occupy the dwelling within 90 days of the loan. Although there is no section which extends the definition to include one-to-four unit residential dwellings,¹¹⁵ the statute clearly falls within a class of statutes which the Legislature has enacted to protect residential homeowners who have mortgages and deeds of trust secured by their property.

A companion statute, Civil Code section 2954.8,¹¹⁶ requires

(a) No impound, trust or other type of account for payment of taxes on the property, insurance premiums or other purposes relating to the property shall be required as a condition of a real property sale contract or a loan secured by a deed of trust or mortgage on real property containing only a single-family, owner-occupied dwelling, except [in 5 specified cases]. . . .

(c) As used in this section, "single-family, owner-occupied dwelling" means a dwelling which will be owned and occupied by a signatory to the mortgage or deed of trust secured by such dwelling within 90 days of the execution of such mortgage or deed of trust.

CAL. CIV. CODE § 2954(a), (c) (West Supp. 1986). Civil Code section 2954(b) provides that the lender must furnish an itemized accounting of the disbursements from the impound account if requested to do so.

114. 59 Cal. 2d 35, 378 P.2d 97, 27 Cal. Rptr. 873 (1963).

115. CAL. CIV. CODE §§ 2924.6, 2954.2, 2954.8, 2954.9 (West Supp. 1986).

116. Civil Code sections 2954.8(a) and (b) state:

(a) Every financial institution that makes loans upon the security of real property containing only a one to four-family [sic] residence and located in this state or purchases obligations secured by such property and that receives money in advance for payment of taxes and assessments on the property, shall pay interest on the amount so held to the borrower. The interest on such amounts shall be at the rate of at least 2 percent simple interest per annum. Such interest shall be credited to the borrower's account annually or upon termination of such account, whichever is earlier.

(b) No financial institution subject to the provisions of this section shall impose any fee or charge in connection with the maintenance or disbursement of money received in advance for the payment of taxes and assessments of real property securing loans made by such financial institution, or for the payment of insurance, or for other purposes relating to such real property, that will result in an interest rate of less than 2 percent per annum being paid on the moneys so received.

CAL. CIV. CODE § 2954.8(a), (b) (West Supp. 1986). Civil Code section 2954.8(c) defines "financial institution." Section 2954.8(d) exempts certain loans from the section's requirements.

creditors to pay interest on money held in impound accounts if the account has been established for purposes related to residential property. This section, passed in 1976, applies to loans executed on and after January 1, 1977. Instead of the phrase "single-family, owner-occupied dwelling" used in Civil Code section 2954, Civil Code section 2954.8 defines residential property as a "one-to-four family residence." Nor does this section mention that the owner must occupy within 90 days of execution of the mortgage or deed of trust. In fact, under the definition used in Civil Code section 2954.8, it is unclear whether a person need occupy the dwelling at all in order to receive protection. The section is mute on this point, but in light of its companion section relating to impound accounts,¹¹⁷ the omission appears to be a legislative oversight. The minor differences in language and the lack of clarity with respect to occupancy should not detract from the purposes behind the legislative scheme: namely, special protection for residential home purchasers.

B. *Pre-Payment Charges*

Civil Code section 2954.9,¹¹⁸ enacted in 1974, provides that the principle and interest on any loan secured by a mortgage or deed of trust on a residential property of four units or less¹¹⁹ may be prepaid without penalty after five years from the date of execution, or may be prepaid with certain, specified penalties within the first five years.¹²⁰ Once again, the Legislature has enacted special provisions for the residential owner.

The amendment of this section made by the 1979-80 Regular Session of the Legislature shall only apply to loans executed on or after January 1, 1980.

117. CAL. CIV. CODE § 2954(a), (c) (West Supp. 1986). See *supra* note 113 for the text of the statute.

118. CAL. CIV. CODE § 2954.9 (West Supp. 1986).

119. Section 2954.9 was amended in 1979 to define residential property as "property of four units or less" instead of "single-family, owner-occupied." Perhaps this is an attempt to bring some consistency to the residential protection statutes.

120. There are numerous reasons why borrowers may wish to prepay their loans. The principal reason is that the home which is security for the loan is sold. Generally the note is paid in full when the new purchasers obtain their loan, thus triggering a potential prepayment penalty. The original borrower may wish to refinance the loan due to a decrease in interest rates. A borrower may desire to refinance in order to pay off the first loan, yet capitalize on the equity, thus permitting the borrower to put extra cash in the bank. See *Union Bank v. Wendland*, discussed in note 90 *supra*. However, under the *Union Bank v. Wendland* holding, borrowers with purchase-money loans who refinance, will lose their purchase-money protection.

C. *Late Charges*

Civil Code section 2954.4, passed in 1975, limits the late payment charges for installments on mortgages or deeds of trust secured by a single-family, owner-occupied dwelling to either (1) six percent of the installment due or (2) five dollars, whichever is greater.¹²¹ This section protects owners of "single-family, owner-occupied dwellings," but does not refer to the "one-to-four family residence" terminology of sections 2954.8 and 2954.9. The Legislature has passed no companion section, limiting the late charges on commercial property loans. Here, as in previously discussed code sections, the homeowner has been granted extra protection as compared to the commercial owner.

D. *Liquidated Damages*

Civil Code section 1675, operative July 1, 1978, governs liquidated damage clauses in the purchase and sale contract for residential property.¹²² If the amount specified as liquidated damages is limited to three percent of the purchase price it is presumed valid. The burden of proving its unreasonableness is placed on the buyer.¹²³ If the amount is more than three percent of the purchase price, the clause is presumed invalid. However, the party seeking to uphold it can establish its reasonableness and rebut the presumption.¹²⁴ The section specifically defines "residential real property" as property that contains not more than four residential units and property that "at the time the contract to purchase and sell is made, the buyer intends to occupy as his residence."¹²⁵ This last provision clearly segregates the treatment of residential property from that of commercial.

E. *Duty of Broker to Inspect Residential Real Property*

Civil Code section 2079, effective January 1, 1986, requires brokers selling property of "one-to-four dwelling units" to conduct an inspection of that property and disclose to prospective buyers any facts affecting the value or desirability of the property that such an inspection reveals.¹²⁶ Thus, the Legislature has shown its intent to

121. CAL. CIV. CODE § 2954.4(a) (West Supp. 1986).

122. *Id.* at § 1675 (West 1985).

123. *Id.* at § 1675(c).

124. *Id.* at § 1675(d).

125. *Id.* at § 1675(a).

126. *Id.* at § 2079 (West Supp. 1986).

provide residential home purchasers with protection not expressly given to purchasers of commercial property.

F. *Disclosures Upon Transfer of Residential Property*

Civil Code section 1134.5, effective July 1, 1985, requires sellers of real property containing one-to-four residential units to provide the prospective buyer with a written statement specifying what, if any, structural additions, alterations or repairs were made during the seller's ownership and whether they were made with the appropriate permits.¹²⁷

Effective January 1, 1987, sellers of real property of "not less than one nor more than four dwelling units" must disclose any conditions affecting the property or defects in items on the property as specified in Civil Code section 1102.6.¹²⁸ The Legislature has actually provided the required disclosure form which lists in great detail, the disclosures that must be made.¹²⁹ With this provision the Legislature demonstrates, once again, great concern for the residential home purchaser.

G. *Other Legislation Protecting Residential Owners*

Specific statutes¹³⁰ govern lenders who offer adjustable rate mortgages that are secured by "residential real property occupied or intended to be occupied by the borrower the principal improvements upon which consist of a dwelling or dwellings for not more than four families."¹³¹ Effective January 1, 1986, lenders offering such mortgages must give prospective borrowers a copy of the most recent publication of the Federal Reserve Board that provides the public with information concerning adjustable rate mortgages.

Civil Code section 2948.5, effective January 1, 1986, prohibits lenders of money secured by a deed of trust on property improved with one-to-four residential dwelling units from accruing interest on the loan prior to close of escrow.¹³²

H. *Summary*

As the above survey illustrates, recent California legislation fo-

127. *Id.* at § 1134.5(a).

128. *Id.* at § 1102.6.

129. *Id.*

130. *Id.* at §§ 1921, 2948.5.

131. *Id.* at § 1918(a)(6) (West 1985).

132. *Id.* at § 2948.5.

cuses on the distinction between owners of residential property and owners of commercial real property. The Legislature has established a public policy of protecting home purchasers. The majority of the statutes define "residential" as "single-family, *owner-occupied*" in order to protect homeowners as opposed to home speculators. By passing statutes with special provisions that apply only to residential purchasers, the Legislature has provided guidelines for the revision of section 580b. The *Roseleaf* purposes should be abandoned in favor of a residential/commercial dichotomy.

IV. PROPOSED STATUTORY REVISIONS

A. *Revitalizing the Fair Value Provisions of Section 580a*

The enactment of section 580d in 1939 brought the demise of the fair value provisions of section 580a.¹³³ Yet, in some common real property foreclosure situations those provisions would be fair and useful today. In order to bring the fair value principle back to life, the author has totally rewritten section 580a, applying it in two important contexts.

First, fair value is rewritten to be a defense to nonjudicial foreclosure on multiple security, i.e. the *Hatch* scenario.¹³⁴ Contrary to the holding in that case, revised section 580a(1) gives the debtor the right to challenge in court the selling price of one parcel of the security, thereby making possible the release or partial release of the remaining security.

The second proposed application of the fair value concept limits deficiencies against guarantors. Under proposed section 580a(2), proving that the fair market value of the security is higher than the sale price will enable the guarantor to limit the deficiency amount to the difference between the proven fair market value and the amount due on the note.

Finally, to ensure that the new fair value remedies are effective and not emasculated by delay, section 580a(3) would establish priority for such proceedings.

The text and analysis of the proposed section 580a revisions follow.

133. See *supra* note 10.

134. See *supra* text accompanying notes 54-55.

1. *Code of Civil Procedure Section 580a(1)*¹³⁵a. *Proposed Text of Section 580a(1)*

NON-JUDICIAL SALES OF MULTIPLE SECURITY

Whenever one obligation is secured by one or more deeds of trust or mortgages on two or more parcels of real property, following the nonjudicial foreclosure of one of the parcels through exercise of the power of sale, the *trustor* may within 30 days of the sale challenge the selling price of that parcel as being below its fair market value. The complaint shall set forth:

- (1) the balance due on the note secured by the mortgage or deed of trust at the time of sale;
- (2) the sale price of the parcel;
- (3) the alleged fair market value of the parcel on the date of sale; and
- (4) the date of such sale.

Before rendering a judgment, the court shall find the fair market value of the parcel sold at the time of sale, taking into account the intrinsic value of the property at the time of the sale. The court may render judgment partially releasing or completely releasing the remaining parcels as security for the balance due upon finding that the fair market value of the parcel sold equaled or exceeded the amount at such sale.

If the trustee's Notice of Sale indicates an intent to sell more than one parcel in a single nonjudicial sale, the trustor may bring an action to restrain the sale until an appraisal of each parcel is made. The court, if necessary to protect the trustor's interest in each parcel, may order that the parcels be sold separately at 30-day intervals, thus allowing the debtor the opportunity to challenge each sale as specified above.

b. *Analysis of Proposed Section 580a(1)*

Proposed section 580a(1) would revitalize the present section 580a.¹³⁶ The significance of section 580a(1) is that following a nonjudicial sale of one parcel of multiple security, the debtor could bar or partially bar the creditor's sale of the remaining security by putting in issue the fair market value of the parcel sold.

This interpretation of 580a was espoused by the plaintiffs in *Hatch v. Security First National Bank*¹³⁷ and was rejected by the

135. In order to be consistent with the established statutory scheme, the proposed statutes have retained their present section numbers.

136. See *supra* note 3 for a summary of the text of present section 580(a).

137. 19 Cal. 2d 254, 120 P.2d 869 (1942). See *supra* text accompanying notes 54-55.

court. The *Hatch* court noted that section 580a, as presently drafted, applies only when the creditor is seeking a deficiency judgment after exhausting all security by exercise of the power of sale. As discussed in section II part A above, section 580a is obsolete due to the subsequent enactment of section 580d which prohibits any deficiency judgment after a nonjudicial sale.¹³⁸ Proposed section 580a(1) would apply in all cases where the creditor is selling additional security, not only where the creditor is seeking a deficiency judgment following a nonjudicial sale. An example will best illustrate this point.

Assume a typical multiple security situation in which one obligation for \$60,000 is secured by deeds of trust on three parcels.¹³⁹ Each parcel is worth \$20,000 at the time the note and deeds of trust are signed. The debtor defaults in payment on the note which has an outstanding balance of \$40,000. The creditor may either give notice of the sale of one of the parcels, or may give notices indicating the sales of all three of the parcels. For purposes of this example, assume the former situation occurs. (The latter will be addressed subsequently.) The creditor sells one of the parcels for \$25,000 at a nonjudicial sale on August 1, 1985. The debtor has 30 days to challenge the selling price as being below fair market value. The debtor alleges that the fair market value is \$40,000, and the court should release the two remaining parcels as security. The court will determine the actual fair market value, which is defined as the intrinsic value of the property at the time of sale.¹⁴⁰ Depending on the court's finding, the court may release or partially release the remaining security.

If the court finds the actual fair market value is \$40,000, the court will order the creditor to reconvey the deed of trust encumbering the remaining parcels. On the other hand, should the court find the property sold has a fair market value of \$30,000, there would be a remaining balance due on the note of \$10,000. The creditor could then hold a second sale of parcel number two. If that parcel is sold for more than \$10,000, the debtor is entitled to the excess, plus he retains the third parcel as the note is satisfied by the sale of secur-

138. *But see* *Walter E. Heller Western, Inc. v. Bloxham*, 176 Cal. App. 3d 266, 221 Cal. Rptr. 425 (1985); *Bank of Hemet v. United States*, 643 F.2d 661 (9th Cir. 1981). *See supra* note 44.

139. The example would also apply to a situation where there is one obligation secured by one deed of trust covering three parcels.

140. *Rainer Mortgage v. Silverwood Ltd.*, 163 Cal. App. 3d 359, 209 Cal. Rptr. 294 (1985).

ity.¹⁴¹ Should the sale bring less than \$10,000, the procedure starts over again with the debtor having 30 days to challenge the selling price as being below fair market value.

While this procedure may appear cumbersome on its face, the advantages outweigh the disadvantages. Obviously, the most significant advantage is that parcels which are sold first will more likely be sold at their fair market value. The beneficiary's opening credit bid should more accurately reflect the property's value, in order to avoid the certainty of future challenge by the trustor. In the past, beneficiaries had a definite incentive to underbid if more than one parcel secured an obligation. The foreclosing beneficiary knew it might be the high bidder at the first sale, even though its bid was below fair market value. The foreclosing beneficiary also knew that it could still reach the remaining parcels to satisfy its debt in spite of its underbid on the first parcel. Even if it were not the high bidder, the beneficiary would receive the proceeds from the first sale and be able to foreclose on the additional parcels if a balance were still owed. Under the proposed legislation, bidding would be more competitive, and debtors would receive a price for their property that more accurately reflects intrinsic value.¹⁴²

Admittedly, creditors could circumvent the statute by dividing the \$60,000 debt into three entirely separate \$20,000 notes, each secured by one of the parcels.¹⁴³ However, a debtor in this instance would then have the option of defaulting on just one of the notes, while maintaining payments on the other two. If the notes have cross-acceleration clauses or similar interlocking language, the debts would be treated as one obligation secured by multiple security.¹⁴⁴

The creditor also may attempt to circumvent the intent of the statute by holding nearly simultaneous¹⁴⁵ nonjudicial sales of all the parcels which were security for the single obligation. Therefore, the legislation permits the debtor to bring an action asking the court to

141. CAL. CIV. PROC. CODE § 727 (West 1980).

142. Another reality should also be mentioned. Financially hard-pressed debtors will have a difficult time raising the funds to hire an attorney to bring the lawsuit to challenge the value of the property sold. This is the problem with much consumer-oriented legislation, and the author has no ready solution to it.

143. This is similar to the *Roseleaf* situation. *Roseleaf*, 59 Cal. 2d at 35, 378 P.2d at 97, 27 Cal. Rptr. at 873. See *supra* text accompanying notes 56-67.

144. A cross-acceleration clause would provide that a default on one note was a default on the others. See R. BERNHARDT, *supra* note 10, § 2.59, at 62-63; *Union Bank v. Wendland*, 54 Cal. App. 3d at 393, 126 Cal. Rptr. at 549.

145. For example, the creditor could schedule the sales of the parcels one after the other on the same day.

restrain the sale of all the parcels until an appraisal of each is obtained. The debtor would have to allege he or she believed the fair market value of one or more of the parcels was sufficient to cover the balance due and that it is therefore unnecessary for the creditor to sell all. The court could then order a piecemeal foreclosure with each sale held at 30-day intervals. This would only be feasible if the number of parcels securing the debt was small. Of course, these would be "nonjudicial" foreclosures,¹⁴⁶ and the debtor's action would, in no way, undermine the creditor's "one form of action" specified in section 726.¹⁴⁷

Instead of ordering piecemeal foreclosure, the court could make a finding as to the fair market value of each parcel and then order the creditor to sell only as many as are needed to pay off the amount due. Under the proposed legislation, the court would be free to make an independent determination of fair market value. Therefore, the determination of that fair market value prior to sale would no longer be inconsistent with the legislative scheme. The procedure of having the court determine fair market value prior to sale is essential where numerous parcels are involved.

Accordingly, the elements of the complaint are essentially the same elements that are currently required in section 580a.¹⁴⁸ The court must know the balance due on the note secured by the deed of trust at the time of sale. The date of the sale must be disclosed in order to ensure that the debtor brought the action within 30 days of the sale. Pursuant to proposed section 580a(3), the action should be calendared as a priority matter so as not to unduly delay the creditor's other remedies.¹⁴⁹

The importance of proposed section 580a(1) is that it will allow the debtor to challenge the selling price of one parcel of multiple security as being below the fair market value, in order to release or partially release the remaining security. This remedy is especially favorable to the debtor during periods of high property value increase. The proposed section 580a(1) will finally provide the debtor

146. Once a judicial foreclosure is held, no other foreclosures are possible because of section 726. CAL. CIV. PROC. CODE. § 726 (West 1980). See *supra* notes 15-17 & 24.

147. The debtor would be bringing an action to determine fair market value; section 726's "one form of action" refers to the creditor's duty to exhaust the security before obtaining a personal judgment against the debtor.

148. In the complaint, the debtor shall set forth: first, the balance due on the note secured by the deed of trust; second, the sale price of the parcel; third, the alleged fair market value thereof at the date of sale; and fourth, the sale date.

149. For example, selling the remaining parcels is another creditor remedy.

the actual relief envisioned by the 1933 enactment of 580a.¹⁵⁰

2. *Code of Civil Procedure Section 580a(2)*

a. *Proposed Text of Section 580a(2)*

GUARANTOR'S RIGHTS TO CHALLENGE THE SALE

Whenever a creditor brings an action to collect the balance due from the guarantor on a note secured by a deed of trust or mortgage on real property which has been sold pursuant to a power of sale, or through a judicial foreclosure sale, the guarantor shall have the right to present evidence as to the fair market value of the property sold as of the date of sale. The court shall render a money judgment against such guarantor for the amount by which the indebtedness with interest and costs of sale and of action exceeds the fair market value of the property as of the date of sale. In determining fair market value, the court shall take into account the intrinsic value of the property at the time of the sale. No action shall lie against a guarantor where a nonpurchase-money note secured by a deed of trust or mortgage on real property has been sold through exercise of the power of sale.

b. *Analysis of Proposed Section 580a(2)*

Before analyzing the purpose of proposed section 580a(2), which gives a guarantor¹⁵¹ the right to challenge the price obtained upon foreclosure, an understanding of the present rather complex situation involving guarantors is necessary. The discussion will first focus on the purchase-money situation and then on the nonpurchase-money situation.

A creditor who holds a purchase-money note and deed of trust can never obtain a deficiency judgment against the principal debtor,¹⁵² regardless of the type of foreclosure chosen. A guarantor, however, may be held liable for the difference between the sale price and the balance due on the purchase-money note, because such a

150. See *supra* section II part A.

151. A guarantor is a person who promises to answer for the debt of another. A guarantor will be held liable should the person primarily responsible for the debt default. CAL. CIV. CODE § 2787 (West 1974).

152. CAL. CIV. PROC. CODE § 580b (West Supp. 1986). See *supra* note 4 for text of section 580b. See also *infra* note 162.

judgment is not defined as a deficiency.¹⁵³ The difficulty arises when the guarantor seeks indemnification from the principal debtor; the debtor's purchase-money protection shields her from the guarantor's action.¹⁵⁴ The guarantor is thus solely responsible for the balance due. The character of the note limits the guarantor's remedy¹⁵⁵ and is not affected by the type of foreclosure the creditor selects.

However, in the nonpurchase-money situation, a guarantor may be substantially affected by the creditor's choice of type of foreclosure.¹⁵⁶ *Union Bank v. Gradsky*¹⁵⁷ illustrates this point precisely. Union Bank nonjudicially foreclosed on its security, then sought the difference between the sale price and the balance due from the guarantor. The guarantor's demurrer was sustained by the trial court and the action dismissed. In affirming the decision, the court of appeal reasoned that the creditor's selection of nonjudicial foreclosure substantially impaired the creditor's remedies against the debtor, and that the creditor was therefore estopped from asserting its rights against the guarantor.¹⁵⁸ The substantial impairment resulted because section 580d bars all deficiency judgments after nonjudicial foreclosure, whether sought directly by the creditor or by way of indemnification by the guarantor. Of course, if the creditor chose judicial foreclosure and obtained a judgment against the guarantor for the balance due, the guarantor could have recovered from the debtor.¹⁵⁹

Presently, a foreclosing creditor who can sue a guarantor for the unpaid balance on the note has little incentive to sell the property at the highest possible price. The creditor may purposely enter a low bid, obtain title to the property, then sue the guarantor for the balance. Therefore, the guarantor, in order to protect himself, must bid at least the balance due on the note at the sale. If this amount is substantial, the guarantor may be in difficulty, as he must bid in

153. See *Freedland v. Greco*, 45 Cal. 2d 462, 289 P.2d 463 (1955), and *Hatch v. Security First Nat'l Bank*, 19 Cal. 2d 254, 120 P.2d 869 (1942), where the courts noted that a guaranty is merely additional security for the obligor's debt.

154. *Bauman v. Castle*, 15 Cal. App. 3d 990, 93 Cal. Rptr. 565 (1971); *Gottschalk v. Draper Cos.*, 23 Cal. App. 3d 828, 100 Cal. Rptr. 434 (1972).

155. A guarantor is not protected by the anti-deficiency statutes. *Everts v. Matteson*, 21 Cal. 2d 437, 132 P.2d 476 (1942). See also *Heckes v. Sapp*, 229 Cal. App. 2d 549, 40 Cal. Rptr. 485 (1964).

156. *Union Bank v. Gradsky*, 265 Cal. App. 2d 40, 7 Cal. Rptr. 64 (1968).

157. *Id.*

158. *Id.* at 45-47, 71 Cal. Rptr. at 68-69. See also *Krueger v. Bank of America*, 145 Cal. App. 3d 204, 193 Cal. Rptr. 322 (1983).

159. The guarantor is treated as a surety. CAL. CIV. CODE §§ 2787, 2810 (West 1974); CAL. CIV. PROC. CODE § 1050 (West 1980).

cash.¹⁶⁰

The proposed section 580a(2) codifies the result in *Union Bank v. Gradsky*¹⁶¹ and addresses the problems encountered by the guarantor in the judicial or nonjudicial foreclosure of a purchase-money deed of trust, and in the judicial foreclosure of a nonpurchase-money deed of trust.¹⁶² In the purchase-money situation, where the guarantor has no right to seek redress from the debtor, it is imperative to give the guarantor the right to raise the fair market value of the property as a defense to the creditor's action for the balance due. This right should extend to the judicial foreclosure of a nonpurchase-money deed of trust, even though the guarantor may eventually obtain the amount owed from the debtor. The following example illustrates how section 580a(2) might be applied.

In order for the debtor to qualify for a \$50,000 purchase money loan she must find someone to guarantee her note. Her parents agree to act as guarantors. The debtor immediately defaults on the obligation, and the creditor nonjudicially forecloses and sells the property for \$40,000 leaving a balance due of \$10,000. Civil Code section 580d prohibits the creditor from seeking a \$10,000 deficiency judgment against the debtor because of the nonjudicial sale. Had there been a judicial foreclosure, section 580b would bar a deficiency. However, the guarantors' separate obligation, which is independent of the primary debt, gives the creditor a cause of action against them. If the guarantors can prove at trial that the fair market value of the property was greater than the \$40,000 obtained, the judgment against them should be reduced accordingly. This would be the result under proposed section 580a(2). If the fair market value of the property had been received at the sale, the guarantors' liability would be substantially reduced or perhaps completely expunged.

Several policy considerations favor adoption of this section. The creditor's opening bid may more closely reflect the property's fair market value because he would no longer be certain of recovering the unpaid balance from the guarantor. Also, it should prevent creditors

160. See CAL. CIV. CODE § 2924h (West Supp. 1986). The cash of course may be obtained through a loan.

161. 265 Cal. App. 2d 40, 71 Cal. Rptr. 64 (1968). See *supra* notes 156-58 and accompanying text.

162. If the property is sold judicially, the debtor presently has the right to raise the fair market value as a defense to a deficiency judgment. CAL. CIV. PROC. CODE § 726 (West 1980). This right has not been extended to guarantors. Professor Bernhardt is of the opinion that the guarantor probably has a fair value defense as well, since this would be consistent with the *Gradsky* rationale and Civil Code section 2809. R. BERNHARDT, *supra* note 10, § 4.47, at 179-80.

who underbid from acquiring the property and a judgment against the guarantor as well, thereby obtaining a double recovery. The guarantor would no longer be compelled to bid at the foreclosure sale, since his liability is measured by the property's fair market value and not automatically by the price obtained at the sale.

3. *Code of Civil Procedure Section 580a(3)*

a. *Proposed Text of Section 580a(3)*

PRECEDENCE

In all proceedings brought pursuant to the provisions of this section, all courts wherein such actions are or may hereafter be pending, shall give such actions precedence over all other civil actions therein, except actions to which special precedence is given by law, in the matter of the setting the same for hearing or trial, and in hearing the same, to the end that all such actions shall be quickly heard and determined.

b. *Analysis of Proposed Section 580a(3)*

Thorough statutory drafting requires inclusion of section 580a(3) in order to ensure the practical effectiveness of the new fair value provisions in sections 580a(1) and 580a(2). Without giving such proceedings priority, delay would undermine this trustors' and guarantors' defense and render the statutory scheme a weak deterrent to undervalued bids at foreclosure sales.

B. *A Commercial/Residential Dichotomy for Section 580b*

Since the enactment of the anti-deficiency legislation in the 1930's, the California courts have been applying section 580b to a variety of factual situations. This task was made considerably more difficult in 1963, when the California Supreme Court in *Roseleaf* articulated what it believed were the two purposes behind that section. An examination of the cases decided subsequent to *Roseleaf* reveals that the purposes espoused therein do not withstand scrutiny. The purported purposes resist every attempt at clear formulation and tend inexorably to give rise to inconsistent holdings that provoke litigation. One major trend has gained acceptance, however, and that is residential purchasers should be protected from deficiency judgments.

Therefore, section 580b has been redrafted to reflect this trend. The statute, as rewritten, would prohibit deficiencies against a pur-

chaser of an owner-occupied, one-to-four unit residential dwelling. On the other hand, vendors and third party lenders would be permitted to obtain deficiencies if their notes were secured by commercial property. Also, section 580b(2) of the rewritten statute would codify dictum in *Brown* that the nature of a loan is determined at its inception.¹⁶³ Finally, section 580b(3) resolves the *Spangler* situation by precluding a deficiency when a buyer purchases property and then borrows money for the construction of a residence.

The text and analysis of the proposed 580b revisions follow.

1. *Code of Civil Procedure Section 580b(1)*

a. *Proposed Text of Section 580b(1)*

RESIDENTIAL PURCHASERS PROTECTED FROM DEFICIENCY JUDGMENT

No deficiency judgment shall lie after any sale of real property which was security for payment of the balance of (1) the purchase price of a one-to-four unit, owner-occupied residence or (2) a loan for the construction of a one-to-four unit owner-occupied residence.

This section shall apply to both vendors and third-party lenders of monies for the purchase of real property.

As used in this section, "owner-occupied" means a one-to-four unit dwelling which will be owned and occupied by a signatory to the mortgage or deed of trust secured by such dwelling (1) within 90 days of the execution of the mortgage or deed of trust in the case of an existing dwelling, or (2) if the dwelling is being constructed, within 90 days after the house is substantially complete, but not later than 90 days after the first of the following occurs:

1. The date of the final inspection by the applicable public agency.

2. The date of recordation of a valid notice of completion.

In all other situations, both vendors and third-party lenders are entitled to a deficiency judgment after judicial foreclosure.

b. *Analysis of Proposed Section 580b(1)*

The California Legislature and the courts have indicated a desire to protect the residential home purchaser from deficiency judgments.¹⁶⁴ Proposed section 580b(1) simply articulates this purpose

163. 41 Cal. 2d 193, 159 P.2d 425 (1953).

164. See *supra* section II part B and section III.

and, in the process, defines the parameters of the protection.

The statute, as proposed, prohibits deficiencies if the security for the debt is a "one-to-four unit, owner-occupied residential dwelling." A definition of "owner-occupied" is essential in order to guard against potential abuses of the section and yet the definition must be flexible enough to accommodate the realities of modern living. Therefore, the proposed definition requires only one of the signatories to the mortgage or deed of trust to occupy the dwelling which is security for the note. This not only makes the section consistent with Civil Code sections 2954 and 2954.4, which deal with impound accounts and late charges,¹⁶⁶ but also takes into account that married couples or unmarried couples living together may separate and, during the separation, one party may retain use of the home.¹⁶⁷ Also, this section recognizes the frequent division of property upon dissolution and permits each spouse to retain his or her interest in the property (usually as a tenant-in-common), while only one occupies the house.¹⁶⁷

In addition, some home buyers, because of inadequate credit, must obtain co-signers on the note and deed of trust to obtain financing. Most of the co-signers have no intention of occupying the premises. Therefore, only one of the signatories should be required to occupy the house.

The second part of the owner-occupied definition requires this one signatory to occupy the dwelling within 90 days of the execution of the mortgage or deed of trust. Again, this is consistent with Civil Code sections 2954 and 2954.4.¹⁶⁸ If the house is being constructed,

165. See *supra* notes 112-15, 121 and accompanying text.

166. Civil Code section 2924.6 states that a due-on-sale clause cannot be exercised when there is a transfer of title due to dissolution. The proposed legislation which requires only one signatory to reside in the premises is consistent with the current trend as illustrated in Civil Code section 2924.6.

167. The person occupying the residence should pay rent to the non-occupying co-tenant. In *In re Marriage of Boseman*, 31 Cal. App. 3d 372, 107 Cal. Rptr. 232 (1973), the court allowed the wife to retain possession of the family residence until the youngest child reached majority. The property was to be sold at that time, and the proceeds divided. The court remanded to the trial court for a determination of exactly how the proceeds would be divided. No mention of rent was made.

168. See *supra* notes 113, 121 and accompanying text.

"Owner-occupancy" is also a widely used requirement for mortgage loan qualifications. FHA regulations require owner-occupancy if the maximum loan guarantee of 95% of the purchase price is sought. There is no owner-occupancy requirement for a loan guarantee of up to 85% of the maximum. *Mortgage Credit Analysis Handbook*, Sec. 3, U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, Handbook 4155.1 MORTGAGE CREDIT (as amended Dec. 1977).

VA regulations require the veteran to certify that he or she will personally occupy the

the owner has 90 days to occupy after it is substantially completed,¹⁶⁹ but no more than 90 days after the final inspection or the notice of completion is recorded.

The difficulty lies in the possible abuse of the section. As presently proposed, an individual could move into the premises within the 90 days, then vacate a week or a month later and use the property as a rental. The purpose of protecting those purchasing homes for their personal use would be defeated.

There are two responses to the foregoing problem. The first is a practical one: few individuals are willing to incur the expense of and undertake the problems encountered in actually moving into a home, unless they intend to remain there for a significant period. Second, the intent of the debtor at the time the agreement is signed must control. Admittedly, intent is a subjective criterion and is difficult to prove, but these difficulties are far from unknown to real property law.¹⁷⁰ Objective facts will be examined. For example, did the debtors actually furnish the dwelling and move in for some period of time? Was this their only address during this period? Was the post office notified of the change of address? Were utilities and telephone service transferred into the purchaser's name? These and other factors can be used to determine the debtor's intent.

If one of the signatories does occupy the premises for a short period of time, and if, upon default and subsequent foreclosure, the creditor desires to obtain a deficiency judgment, there should be no bar to litigating the intent issue in determining the creditor's right to that deficiency. There is a chance that default might not occur for years after the debtors vacate, and proof of intent by either party

property as his or her home:

[T]he words "personally occupy the property as his or her home" mean that the veteran as of the date of his or her certification actually lives in the property personally as his or her residence or actually intends upon completion of the loan and acquisition of the mobile home to move into the home personally within a reasonable time and to utilize the home as his or her residence.

38 C.F.R. § 36.4206(b) (1984).

169. The term "substantial completion" is also used in section 337.15 as the beginning of the ten year period within which a person must sue a real estate developer for damages arising from latent defects.

170. For example, Professor Hetland states:

Any real property transaction intended by the parties to secure an obligation and not otherwise classifiable is a mortgage. Moreover, parol evidence is admissible to show the intent of the parties, i.e., to show that a transaction appearing to be something else actually was intended as security for an obligation. (citations omitted).

J. HETLAND, *supra* note 10, § 9.4, at 185.

would be extremely difficult.¹⁷¹ However, since most people who obtain loans to purchase a personal residence do so in good faith, it seems unnecessary to address this issue.¹⁷² In the author's opinion the proposed statute, because of its simplicity, and because it does leave open the possibility of litigating intent, best accomplishes the Legislature's purpose of protecting the homeowner.

Section 580b(1) explicitly states that neither vendors nor third-party lenders may obtain a deficiency judgment if the note is secured by a residential dwelling. This is simply a codification of present law.¹⁷³ The section further codifies the result obtained in *Prunty v. Bank of America*¹⁷⁴ and extends purchase-money protection to loans obtained for the construction of a residence.

However, present law is changed to the extent that, under the proposed statute, vendors, as well as third-party lenders, may obtain a deficiency in all other cases. The present section 580b bars vendors from deficiencies, even if the note is secured by commercial property.¹⁷⁵ This prohibition serves no valid purpose and has been criticized repeatedly. As discussed previously, several exceptions have been judicially created.¹⁷⁶ The proposed language eliminates the en-

171. The present section 580b, amended in 1963, bars lenders of purchase-money secured by a dwelling for not more than four families from obtaining a deficiency where the purchaser occupies entirely or in part. The author has found no reported cases in which the owner-occupancy or residency issues have been litigated. Thus, owner occupancy under the proposed legislation should not be a major issue.

172. Alternatives to cover situations where the purchaser was attempting to circumvent potential personal liability were considered and rejected. For example, the statutes could give the creditor the right to bring a declaratory relief action to determine whether the debtors have purchase-money protection as soon as the premises are vacated in order to insure that the facts surrounding the intent issue are fresh. The legislation could be drafted to give purchase-money protection only to those purchasers who occupied the premises for a certain period of time. But how would the time period be calculated? Would it begin at the time the note and deed of trust are signed, or upon actual occupancy? Is actual occupancy measured from the time the occupants first spend the night? Would the period of occupancy have to take place consecutively, or could the occupants leave the premises for a period of several weeks or months, and then return, tacking the subsequent period onto the initial period? If the right to protection from a deficiency had not "vested" before default occurred, the question might arise whether the debtors, although occupying the premises at the time, would be protected. Drafting a statute which takes such details into account is possible but not necessary.

173. See *supra* note 4 for text of section 580b.

174. 37 Cal. App. 3d 430, 112 Cal. Rptr. 370 (1974). See *supra* text accompanying notes 97-99.

175. CAL. CIV. PROC. CODE § 580b.

176. In the recent case of *Shepherd v. Robinson*, 128 Cal. App. 3d 615, 180 Cal. Rptr. 342 (1981), a vendor who participated in the refinancing and second sale of the commercial property was denied a deficiency judgment under the provisions of Civil Procedure Code section 580b. When the holder of the senior note nonjudicially foreclosed, the vendor's second deed of trust was extinguished. The court held that the seller served as a "necessary party" in

tire problem and extends to vendors rights identical to those of third-party lenders.

2. *Code of Civil Procedure Section 580b(2)*

a. *Proposed Text of Section 580b(2)*

ASSUMPTION OF PURCHASE-MONEY LOAN

The nature of a loan secured by a deed of trust or mortgage is determined at its inception. If the original purchaser was protected from a deficiency judgment under section (1) above, the subsequent grantees who assume that loan are likewise protected.

b. *Analysis of Proposed Section 580b(2)*

It has frequently been held that the nature of a loan is determined at its inception.¹⁷⁷ Proposed section 580b(2) simply codifies this rule. If a loan is originally defined as purchase-money under section 580b(1) and is assumed, it retains purchase-money protection.¹⁷⁸ Conversely, a nonpurchase-money loan remains such even if assumed by someone who could have qualified for purchase-money protection. The primary benefit of such a rule is certainty; neither the lender nor subsequent assuming borrower need be concerned with reclassification of the loan during its life.

Under the Garn-St. Germain Act¹⁷⁹ which was enacted on October 15, 1982, all due-on-sale clauses in loans secured by mortgage

the refinancing of the property, and retained his status of seller because of this. The *Shepherd* decision, however, has been criticized. One commentator explains that "the court's reasoning is tenuous and [the author] recommends caution in relying on it." R. BERNHARDT, *supra* note 10, § 4.32, at 36.

Under the proposed legislation, the vendor who carries back a second deed of trust on commercial property is allowed a deficiency judgment. This legislation would eliminate decisions such as *Shepherd* which do not meet the purported end of protecting the residential homeowner.

177. This was central to the *Brown* holding. Dicta in several cases support this. *Stockton Sav. & Loan Bank v. Massanet*, 18 Cal. 2d 200, 114 P.2d 592 (1941); *Jackson v. Taylor*, 272 Cal. App. 2d 1, 76 Cal. Rptr. 891 (1969); *Paramount Sav. & Loan Ass'n v. Barber*, 263 Cal. App. 2d 166, 69 Cal. Rptr. 390 (1968).

178. In recent years, due to rising interest rates, buyers frequently wanted to assume the seller's old loan instead of financing the balance due on the purchase price with a new loan at a higher interest rate. As rates decrease, buyers will borrow new funds to pay off the seller's original higher interest rate loan.

179. 12 U.S.C. § 1701j-3 (West Supp. 1986). The regulations pertaining to the Act are codified in 12 C.F.R. §§ 590, 591 (1985).

or deeds of trust, regardless of date of origination, are enforceable.¹⁸⁰ Lenders thus have final authority to decide whether to allow a loan to be assumed. The lender's decision may well rest in part on whether the assuming grantee would have purchase-money protection if he or she obtained a new loan. The central factor in the lender's decision, however, will be the interest rate on the note to be assumed relative to current market rates.

There is no reason to allow the creditor to obtain a deficiency if a loan, which was originally purchase-money, is assumed. Since the lender had no recourse against the original borrower, to permit the lender to sue the assuming grantee, places the lender in a better position than it was in originally. Had the lender desired to be able to obtain a deficiency against the new grantee, it could have exercised its due-on-sale clause.

By maintaining the character of a purchase-money loan throughout the life of the loan, regardless of subsequent assumptions, the lender's rights are not defeated in any way, but a potential windfall to the lender is averted. From the loan's inception, the lender had no expectation of obtaining personal liability on the debt, and an assumption agreement should not change that. The only real benefit of having a new owner agree to assume the debt is that it helps ensure the lender will not exercise its due-on-sale clause. While an assumption agreement also generally releases the original borrower from any liability as a signatory on the note, in the purchase-money context there is no personal liability. Therefore, such a release is unnecessary.¹⁸¹

Under the proposed statute, the buyer who assumes a nonpurchase-money loan will be subject to personal liability, just as the original borrower was. If the residential buyer desired purchase-money protection, he or she has only to take out a new loan rather than assume the old loan.

To illustrate the nonpurchase-money situation, assume a person wanted to buy a residence as investment property. The buyer borrowed part of the purchase price from a lender other than the seller and secured the note by a deed of trust on property purchased. The buyer has personal liability, since the note is not purchase-money under section 580b. If he or she sells the property to someone who assumes the note, the subsequent owner likewise has personal liabil-

180. The Garn Act window period closed on October 15, 1985. 12 U.S.C. § 1701j-3(c)(1) (West 1980 and Supp. 1985).

181. A release may be important if the seller is attempting to obtain a new loan.

ity. Even if the new owner is occupying the property as his or her personal residence, the personal liability on the original note continues. It is the subsequent owner's option to take out a new purchase-money loan to protect against personal liability. Perhaps the interest rate on the nonpurchase-money loan is attractive enough to offset the danger inherent in personal liability. In any event, the lender once again should not have its original rights affected by the mere fact of assumption.

The proposed legislation codifies the case law which has developed through the years. The rule is simple and predictable: the character of the loan, once ascertained, never changes.

3. *Code of Civil Procedure Section 580b(3)*

a. *Proposed Text of Section 580b(3)*

SUBORDINATION AGREEMENTS

No deficiency judgment shall lie after any sale of real property which was security for a loan used for payment of the purchase price of land and which was in fact subordinate to a construction loan for a one-to-four unit, owner-occupied residential dwelling as defined in section (1).

b. *Analysis of Proposed Section 580b(3)*

Individuals who desire to build their own homes frequently must finance the purchase of the lot and then subordinate this loan to one for construction of the residence. Either the vendor or an independent lender may hold the subordinated note. In either case, under proposed section 580b(3), no deficiency judgment could be obtained if the purchaser defaults and the subordinated lender is sold out.

This is a logical extension of the protection to be given to the residential purchaser. However, a specific provision is necessary in order to avoid any possibility of the arguments in *Spangler v. Memel*¹⁸² being applied.

As discussed in section II part B subpart 3, *Spangler* involved a vendor who agreed to subordinate the balance of the purchase price on her lot to a construction loan for a commercial building. In permitting the sold-out junior vendor to sue on her note, the California Supreme Court reasoned that the seller was in no position to predict

182. See *supra* note 73.

the fair market value of the completed structure. Thus, the seller could not overvalue the property and section 580b's purpose of discouraging overvaluation would not be served by prohibiting a deficiency.

The same analysis could apply where the buyer was constructing a residence instead of an office building. Here, too, the subordinated seller has no way of being certain that the value of the completed structure will be sufficient security for both the construction loan and his subordinated note. However, given the basic premise that the legislative policy is to protect residential purchasers, this policy should prevail in any situation where a person desires to own or construct a personal residence. Any lender who subordinates to a construction loan for a residence as defined in proposed section 580b(1) should be in the same position as the vendor who takes back a second to secure the purchase price of a residence; no deficiency should be permitted. This is guaranteed under proposed section 580b(3).

C. *Clarifying the "One-Action" Rule of Section 726*

The need to improve the precision and clarity of section 726 in order to effectuate the Legislature's plain intent is exemplified in *Bank of America v. Daily*,¹⁸³ where, for lack of an explicit definition of "action" in the 726 context, the court imposed a "double sanction" on the creditor. Similarly, the statute lacks both an express statement of the remedies available to debtors under section 726 and the policy underlying the rule. The proposed amendments would cure these defects in the statute.

1. *Code of Civil Procedure Section 726*

a. *Proposed Text of Section 726*

DEFINITION OF ACTION

[The following definition of "action" would be added to section 726 (a)]:

As used in this section, the term "action" means "an ordinary proceeding in a court of justice by which one party prosecutes another of the declaration, enforcement, or protection of a right, the redress or prevention of a wrong, or the punishment of a

183. 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984). See *supra* text accompanying notes 104-08.

public offense." (This definition is taken from Code of Civil Procedure section 22.)

b. *Analysis of Proposed Definition of "Action"*

The first suggested revision would define "action" as "an ordinary proceeding in a court of justice. . . ."¹⁸⁴ The purpose of this addition is simply to incorporate the self-evident proposition that section 22 applies to section 726. This is necessary because of the language in *Bank of America v. Daily*¹⁸⁵ where the court held that a bank's setoff from a trustor's checking account, a procedure devoid of court involvement, was an action for the purposes of section 726.¹⁸⁶ The result of this ruling was that the bank was not allowed to either request a judicial foreclosure of the property or ask for a personal judgment against the debtor,¹⁸⁷ thus resulting in a "double sanction."

2. *Policy of Section 726*

a. *Proposed Policy of Section 726*

[A new subsection would be added to section 726 as follows:]

The legislature declares that it is the express policy of the state to require a creditor to look to the real property security first before reaching a debtor's other assets. This section shall be liberally construed to effectuate this purpose.

b. *Analysis of the Proposed Policy of Section 726*

The court in *Daily* could have prohibited the bank from foreclosing after the setoff by examining the policy behind section 726 and holding that the policy of requiring the creditor to foreclose first was violated. Thus, the proposed amendment would expressly incorporate this policy statement into the statute. If a creditor were then to devise some new method of reaching a debtor's unpledged assets prior to foreclosure, a court could impose a sanction without blatantly distorting the meaning of the word "action" in the section.

184. California Civil Procedure Code section 22 defines "action" in exactly the same language as that suggested here. CAL. CIV. PROC. CODE § 22 (West 1985). A reference in section 726 to section 22 would be sufficient.

185. 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984).

186. *Id.* at 771, 199 Cal. Rptr. at 559.

187. *Id.* at 772-73, 199 Cal. Rptr. at 559-60.

3. *Debtor's Remedies Under Section 726*

a. *Proposed Addition to Section 726*

[The following section would be added to section 726(a):]

The creditor or trustee at the creditor's direction shall sell all the property which is security for a debt before seeking a deficiency judgment pursuant to subsection (b). If a creditor does not do so, a debtor may compel the creditor to foreclose by pleading and proving that the debt was secured by real property. If the debtor does not compel the creditor to foreclose on all the security in the creditor's one action, the creditor may obtain a judgment against the debtor for the balance due but may not foreclose on the security at a later date. The security shall be declared free of the mortgage or deed of trust at the debtor's request.

b. *Analysis of Proposed Section 726's Debtor's Remedies*

The last proposed addition to the statute would clarify the sanction a court should impose if the creditor fails to foreclose on all the security first. As mentioned, the *Daily* court held that the creditor could neither reach the security nor obtain a personal judgment against the debtor.¹⁸⁸ This doubly benefits the debtor, as he or she now owns the property free of the lien and does not have to repay the money which was received when the loan was taken out. The proposed language would remedy this unfair situation by stating that the creditor who violated section 726 by not foreclosing on all the security first could proceed to obtain a personal judgment against the debtor but could not reach the security.¹⁸⁹

As presently written, section 726 does not specify the debtor's remedy should the section be violated. By incorporating subsections specifying the remedy and stating the policy of the statute, courts will be able to better evaluate whether the policy has been violated and then would know what sanction to impose. The amendments are necessary in order to nullify the erroneous interpretations given to the section over the years.¹⁹⁰

188. *Id.* For a discussion of why the double sanction should not be imposed, see Rowan & Mertens, *supra* note 102, at 73.

189. See *supra* note 102 and accompanying text. In addition, it should be noted that if a creditor were allowed to foreclose after a setoff as in *Daily*, the fair value provisions of section 726 would be circumvented. See Rowan & Mertens, *supra* note 102, at 77.

190. The erroneous interpretations have arisen largely because courts have either misunderstood early holdings interpreting the statute or have relied on commentators who appar-

V. CONCLUSION

In view of the legislative trend of extending residential home purchasers protection not available to commercial property owners, the anti-deficiency statutes are obsolete and in need of major revisions. Therefore the author has redrafted the statutes in order to accurately reflect the legislative desire to protect homeowners.

Section 580a has long been of no practical value. In its place, the author proposes fair value provisions designed to provide both property owners who give multiple security for a debt and guarantors, certain rights which they do not clearly possess under the present statutes.

As rewritten, section 580b would embody the commercial/residential purchaser distinction which the Legislature appears to have adopted. Thus, the courts would no longer be burdened with the *Roseleaf* purposes; the new statute's explicit standards would be applied consistently and with confidence. The revised section 580b would remove the gray areas under the present law by assuring anti-deficiency protection for both a grantee who assumes a purchase-money loan, and for a buyer who purchases land and then borrows money for construction of a residence.

In addition to the substantial changes to sections 580a and 580b, the author recommends clarifying the "one-action" rule in section 726 so as to eliminate uncertainty that has led to questionable judicial decisions under the present statute.

The proposed legislation, if adopted, would not only provide clear guidelines for the courts but it would also reflect the growing concern for residential purchasers which has become apparent in recent years.

ently did not have specific situations in mind. For example, *Daily* relied on *McKean v. German-American Sav. Bank*, 118 Cal. 334, 50 P. 656 (1897) in finding that the setoff was an "action." A careful reading of *McKean* will show that it did not hold that a setoff was an action. Rowan & Mertens, *supra* note 102, at 75-76.